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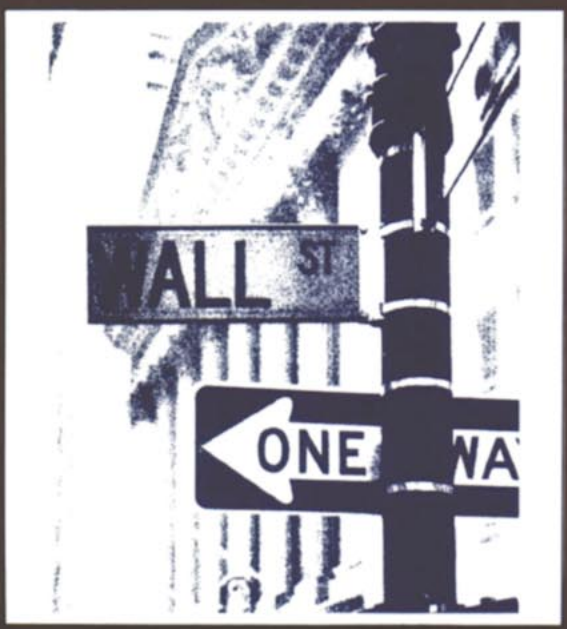

"Insider Trading": The Moral Issue

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IDEAS ON LIBERTY

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Give Thanks for Freedom

The Pilgrims are usually credited with having celebrated the first Thanksgiving in this hemisphere. And rightly so. However, the custom of giving thanks became nationwide only much later.

Our first President, George Washington, was grateful for the Constitution. In his view, it offered an opportunity for the new nation to start afresh. On October 3, 1789, he proclaimed one day nationwide, Thursday, November 26, for "acknowledging with grateful hearts the many and signal favors of Almighty God, especially by affording them an opportunity peaceably to establish a form of government for their safety and happiness." In Washington's view, the new Constitution limited the power of government, leaving the people free "to perform our several and relative duties properly and punctually." He gave special thanks also "for the civil and religious liberty with which we are blessed."

Ever since Civil War time, beginning with Abraham Lincoln, our Presidents have issued a similar Proclamation each year, setting aside one special day for giving thanks. Thanksgiving Day has become a national holiday, celebrated by some in prayer, by some in sports and parades, and by others with feasts.

We in this country today enjoy economic prosperity on a scale unequaled in any other time or clime. We pride ourselves on our "American way of life." We truly have a great deal to be thankful for. However, as we count our blessings this November, let us give some thought and thanks to the freedom on which these many blessings rest.

It is commonplace to say that the colonies were settled, the West explored, the nation developed, and the country populated by individualists who wanted to be independent. The tired, the poor, the huddled masses who yearned to be free came to our shores. They sought the opportunity to speak, to write, to work, to worship, and to live where and as they chose. The Statue of Liberty now symbolizes

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their desire to escape oppressive government and to seek opportunity in this land of the free.

We still pay lip service to freedom. But many have forgotten our ancestors' fear of oppressive government. Many have come to rely on some government privilege or protection. We no longer understand how such piecemeal interventions, regulations, and controls can gradually erode our independence. We no longer realize what a big debt we owe to freedom and to the freedom of others.

Practically everything we have today has stemmed from the ideas, initiative, and efforts of free men and women, working and producing together. The food, clothing, shelter, and luxuries we now enjoy represent the output of men and women working, planning, and producing in voluntary cooperation with one another. Countless individuals have labored without being coaxed or coerced by government to till the soil, cultivate the fruits and vegetables, harvest the grains, herd the sheep and cattle, build the skyscrapers, erect the churches and synagogues, build the factories, manufacture the automobiles, trains, planes and buses, weave the textiles, invent the radio, moving pictures, television, computers, appliances, and other conveniences, produce the medicines, build the hospitals, write the books and stories, print the newspapers, compose the music, produce the plays and films, and so on, that all of us now use and enjoy. We are apt to forget that this entire process of voluntary social cooperation could disintegrate if government obstructions are permitted to expand and to proliferate.

Countless individuals, each with his or her own particular aptitudes, talents, and interests, have contributed to the good life we now enjoy. In giving thanks this year, therefore, let's count our blessings. But let's do more than that. Let's not forget the debt we owe to free men and women everywhere, whose ideas, initiative, innovativeness, energy, and efforts contribute to our well-being. In all humility, therefore, let's give thanks also to the freedom that makes our blessings possible.

— BBG

Peru's Informal Economy

Peru's Institute for Liberty and Democracy (ILD) estimates that 40 per cent of the nation's GNP is produced by the subterranean economy. "Informal" (unlicensed) entrepreneurs build houses, repair motor vehicles, and run their own small factories. In the capital of Lima, half the population lives in housing built by the informal sector, and informal entrepreneurs provide 95 per cent of public transportation.

Why are so many workers and entrepreneurs operating without licenses and other government permits? Red tape. Peru has more than 500,000 laws and executive orders. When ILD tested the bureaucratic waters by trying to open a small workshop with two sewing machines, it took 289 days to get the needed permits. It took a group of low-income families almost seven years to acquire a vacant lot to build a house. And it takes an average of two decades to obtain formal title to a home. When people are poor, they can't afford the time and expense of dealing with an endless parade of bureaucrats.

But ILD cautions that the informal sector is far from an ideal business environment. There are no legally enforceable contracts, businesses can't incorporate, capital is difficult to acquire, and entrepreneurs must self-insure. Still, for millions of people in Peru and other nations, the subterranean economy is the only hope for survival.

Bruce Alan Johnson, an American businessman who recently visited Peru, helped launch a young Peruvian on an entrepreneurial career. Mr. Johnson recounts his experiences in his article beginning on page 404.

—BJS

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Davíd: From Beggar to Entrepreneur—In a Day

by Bruce Alan Johnson

The difference between education and intelligence is this: intelligence will make you a good living.

—Charles F. Kettering

The backstreets of Lima, Peru, are cobblestoned alleys of poverty and squalor. Yet, as G. K. Chesterton remarked, it is the task of the artist always to see beauty behind the masks of even the most depressing human suffering. To be sure, amid these narrow, winding lanes there are countless colonial balconies overhanging the cobblestones, many of them dating back to the early nineteenth century and all of them reflecting the grace of a departed era.

While walking in these backstreets one Saturday afternoon this winter, I heard a young boy's voice call out to me, in half-educated Spanish, "Señor, you got a hundred *soles* [about 22 cents] for a starving boy?"

I paused. Third-World cities are crowded with hungry children, many of them orphans, as families migrate to the cities in hopes of finding the employment that simply isn't available. When I turned around and saw him, I faced a boy of about ten or eleven years, with black hair and a torn T-shirt. He walked toward me, and his eyes fairly flashed with intelligence and the wariness that only the "street-wise" seem to acquire—a special toughness that is their very defense against the hustlers, the petty thieves, and the unprincipled.

"You're chubbier than I am!" I answered him, smiling.

"Yeah, well, it works on *most* tourists," he said lamentedly.

"Ah, but I'm not a tourist!" I thought I had him.

"I know. There's something about you. . . ." The street wisdom again? "Well, thanks anyway. *Hasta luego*."

"I was just looking for a tamale and some good Peruvian coffee," I said in a loud voice as he turned away from me. "You know any good places?"

His eyes smiled back, and he approached me briskly. "*Amigo!* I know the best tamales in all of Lima!" I believed him. And he was right.

At a tiny, rundown tamale stand only a few kilometers from the crystalline glamor of the Sheraton, we stood and ate hot tamales wrapped in cornhusks. And drank coffee. I had seen suffering children all over the world, for years. I always had given them money, but what was it about this boy that told me there was something extra—perhaps something even redeeming? At this point, it was only a vague feeling.

"Señor," he said suddenly to me, "you like Peruvian wine?" Peru makes one of the best rosé wines in the world.

Mr. Johnson is chairman of Four Seasons International Corporation (Raleigh, North Carolina), an international business consulting firm. He has had 18 years of experience in developing countries.

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"You're too young to like wine," I said gruffly. At least I thought I had said it gruffly. But his eyes twinkled:

"Ah, señor, can one ever be too young to love the nectar of the gods?" Then I knew what had captured me: not just his obvious intelligence, but his passion and love for life. Despite the horrors of daily living on the streets—and off his wits—and despite the taunts of other children striving like him to eke out a bare subsistence, this boy had risen above them by seeing beauty where they saw terror, and by seeing hope where they saw only despair. I was hooked.

"*¿Como se llama Usted?*" I asked him, for it had just occurred to me that we didn't even know each other's names. I continued to address him in the polite rather than the familiar form used normally when talking with children. This he clearly was not accustomed to, and he responded enthusiastically. You've recognized my dignity, he seemed to be saying in return.

"Davíd!" he answered with gusto. "*¿Y Usted?*"

David. The slayer of Goliath. He who rose to greatness out of his love for his own people. I tried to shake off what was clearly only a romantic image of a small street orphan in the modern-day backstreets of a developing city.

"Bruce!" I answered back. But I knew he was not going to be able to pronounce it without considerable difficulty. I was taken aback when he modified it so quickly to suit his Spanish and his own sense of propriety:

"Ah, Señor Brúce!" he said with satisfaction, pronouncing the Scottish name BROO-say. I was quite used to this variation by adults, but had never heard a child adopt the name so readily. I was pleased.

He was licking the cornhusk wrappers of his tamale, and I took the hint to order him another. He beamed.

"Davíd," I began, "What do you want to do? How do you want to live?" He obviously was not in school but, I was to learn later, he had taught himself to read phonetically, and was the proud owner of two bedraggled copies of Miguel de Unamuno's novels, as well as an even more dog-eared paperback Spanish-English dictionary.

He stared straight into my eyes as he answered with resolution I had never heard in any child. "I want to have my own shoeshine business."

"Really?"

"Really!" A fierce determination underscored his answer—not arrogance, just the plain determination of someone who knew what he wanted and knew *somehow* that he would get it. How could anyone fail to be moved by this little boy's confidence and precocity?

Shoeshining is an occupation of thousands of young boys throughout the developing countries of Latin America, Africa, and the Middle East. Most of them use cheap polish and no skill in their craft, but it struck me at once that here might be an exception.

"Davíd, going into business entails capital, and I know you know the meaning of that word. Have you any money at all?"

He reached into the side pocket of his tattered and filthy jeans, and withdrew a small bundle of 500-*soles* banknotes. Altogether, he had the equivalent of nine dollars. "Where did you get this?" It was a good deal of money for a small boy in Peru to have.

"I saved it from *turistas*." I believed him. Tourists—especially American tourists—typically have hearts of gold, and beggar children know this only too well. The next question was easy.

"Davíd, I believe you. And I believe that you're serious about wanting your own business. I'll tell you what." His big eyes were fixed on mine, unmoving. "I'll be your venture capitalist, and I'll explain what that means. It means that I'm willing to provide the rest of the money you need for your venture, but only if you're willing to share part of your earnings with me: If I'm going to invest in you, I deserve a return on my investment. Fair?"

I had expected him by this time to look puzzled. I should have known better.

"But capitalism is evil—it's what makes us starve!" he spit back. It really wasn't surprising. Throughout the Third World, this time-worn cliché is being bandied about by sociologists and academics at an alarming rate. Now I was confronted by an inordinately sensitive and capable little boy who did not have the tools with which to refute something that I sus-

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pected he knew, inside, was false.

"Davíd, in the years before your new President, did you live better or worse than you do now?"

"Things were not good before President Belaúnde," he replied. "My friends have told me bad things."*

"Exactly. And that was because your friends were not allowed to practice what they wanted to do, and they were not allowed to keep what they had earned by their own hands. Right now in Perú, anyone in the country can make a living any way he sees fit, just so long as he doesn't break the law." He nodded. "Davíd, I just paid this lady for some tamales and some coffee. Now, she's a capitalist because she's in business for herself. But when I paid her, who benefited?"

He paused a minute. "Well, I guess *both* of you did!" He knew he was right. His eyes showed me that he was beginning to catch on to an idea he had only felt before.

"Exactly! Now, what if she had wanted 1,000 *soles* for a tamale, rather than only 25?"

"Hey, amigo, you would have been a real *gringo turista* if you had paid that price!" He was genuinely excited, and it was contagious; two other customers at the tamale stand were watching us now, smiling.

"Yes, I would have been just that. But more likely, I would have refused to buy them from her, right?" He nodded again, enthusiastically.

"In a business transaction, the price of anything is determined not by what *you* want to charge, but by what the customer is willing to pay. In other words, the market reflects fairness, just so long as no one is allowed to get away with fraud."

"Well, amigo, there's a lot of jerks in this town, and they rip off everyone. . . ." I interrupted him.

"There's a fine line, Davíd, between fraud and just foolhardy buying habits. If you get me to pay you, say, 100,000 *soles* in advance for a car, and then deliver me an old horse, *that's* fraud. But if I willingly walk up and buy your horse, after looking it over, even though I might know that neither the horse nor the price are such a good deal, then I'm just plain stupid. In other words, it's *my* responsibility to look after myself, not yours and not President Belaúnde's."

"Okay. *Bueno*. So how much am I going to charge?" Smart kid, but moving in the fast lane before he's learned to drive, I thought to myself, amused.

"What's the going price for a shoeshine in Lima?" I asked.

"I guess 275 *soles*," he answered quickly. About 65 cents.

"And do you think you'll be as good as the other boys in Lima? Remember, they're your competitors."

"I'm *better!*" he shouted. "I'm better than all of them!" He believed that, and so did I, because enthusiasm is the father of excellence.

"Now *that's* the spirit! Okay. So why don't you do this: offer a better service, and try charging just a few *soles* more for it. If you're really that good, people will pay for the difference, quite happily."

"Really?"

I ruffed his hair. "Really!"

I put my arm on his shoulder and pulled him back into the lane. "So let's go and get your equipment," I said. It was like suggesting a glass of water to a parched desert hiker.

As I had expected, young Davíd had picked out his equipment weeks before, in hopes that he might somehow be able to buy it soon. In a small, dingy, general-goods store, we found a shoeshine box, well used. We then went around the corner to a shoe repair shop to find the polish, brushes, and rags he needed. Altogether, the total came to about $18.00. (Shoe polish is imported from North America, and goes for a very steep price, after customs duties are added.) So Davíd was in debt for $9.00.

* Peru, under Mr. Garciá's administration today, is suffering once again the impoverishing effects of socialist policies. As Michael Novak remarks in his new book, *Will It Liberate? Questions About Liberation Theology:* "In Peru, the liberal activist Hernando de Soto has pointed out that state regulation almost totally strangles the economic liberties of the lower classes. Some 2.5 million street vendors, artisans, and manufacturers work without legal protection because they cannot cut through governmental red tape. Ninety-five percent of Lima's public transportation (buses and taxis) are run by this illegal 'informal sector.' Forty-three percent of all Peruvian housing built during the past 30 years has been built informally. Sixty percent of Lima's food is distributed informally. To build homes requires 7 to 14 years to receive government authorization. It can take 289 days to form a legal corporation, and the cost in bribes, government fees, and foregone income is five times the average worker's annual earnings, some $8,700 [US]."

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Now it was my turn to be eager. Where had he decided to set up shop?

"At the Plaza San Martín!" He responded.

"What? Along with twenty other shoeshine boys?" It was time for a little marketing lesson.

"Yeah, but I'm *better,* remember?"

"And those twenty competitors already have their steady customers. So how are you going to break into a market that's already filled?" I tried to be firm without sounding disappointed in him.

"*Está bien.* But where can I go, where there's lots of people?" He was sincere in his concern. Plaza San Martín was one of the central hub areas of Lima.

"The Sheraton Hotel, Davíd." I handed the shoe box over to him. "That's where there are busloads of *turistas* with big hearts and lots of dusty, dirty shoes!"

He was grinning broadly now. "Ay, *gringos*!" I wasn't sure I liked his enthusiasm this time.

On our way to the Sheraton, we discussed the fact that there were already a few boys shining shoes near the front door of the hotel. "But there aren't *twenty* of them, are there?"

We talked about fairness, and about competing without harming the other boys. Their skills should be the only standard by which they will win business. Besides, I urged him, sometimes there will be more *turistas* outside than he could handle, so sharing the business was in the best interest of everyone. He accepted this, but grudgingly.

Moments after arriving at the Sheraton he popped the question that I had completely overlooked. "Hey, Señor Brúce—how much do you get from me? Half?"

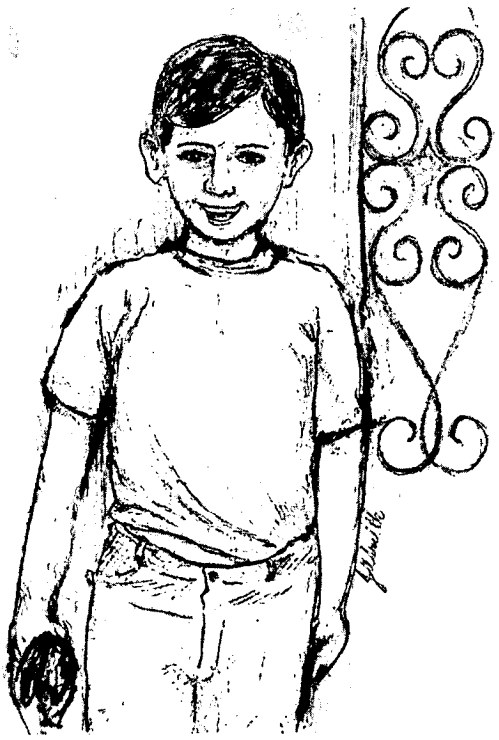
I paused to study this young entrepreneur with the stained jeans. "One per cent," I answered. He stared back.

"How much is that?" I had forgotten that his education was sparse.

"That means I get one *sole* out of every hundred you collect," I answered.

He beamed. "You *are* a *gringo,* amigo!"

Five minutes later, I had talked an unsuspecting British tourist into stepping outside for the best shoeshine of his life. "Oh, really now," he had objected, "I don't at all take to these little urchins rubbing cordovan polish all over my slacks, you know, what?"



Davíd

Yes, I knew. But, a few minutes later, he acquiesced, probably out of intrigue for this strange Yank who was so taken with the little enterprise.

We approached Davíd with some trepidation. After ascertaining that the hesitant British gentleman spoke only tourist Spanish ("How much is that in *real* money, *por favor?*") I looked sternly at my young charge.

"Davíd, if you use the wrong color or get one smitch of polish on this man's slacks, I'll chase you all the way over the Andes into Ecuador!" He knew I meant it, but he was amused nonetheless.

His brown eyes said, "Okay, boss!" My own eyes said, "Maybe I'd better go up to my room until this is all over and done with. . . ."

Davíd went to work with a ferocity and steadiness that was intoxicating. I decided I didn't need to disappear, after all. Even the British gentleman was taken aback by the skill that this little boy was displaying—snapping his polish cloth about with the same panache as Jascha Heifetz wielded a bow. Moments later,

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it looked as if Davíd had created a new pair of shoes. I was visibly relieved. So, I could tell, was his first customer.

"That *is* a smashing job, young man!" said the man.

Davíd looked at me, puzzled. "¡*Fantástico*!" I flashed back. He grinned proudly.

"How much do I owe you?" Davíd, of course, knew the words "how much," probably in more languages than Berlitz. He looked at me. I turned both palms up, to signify that it was his decision completely. I only hoped that he had done a minute's thinking about what we had discussed that afternoon. He had.

"*Trescientos soles, por favor, Señor!*" I smiled. Three hundred soles—three and a half cents above the competition, for a job worth much more.

The British tourist dug into his pocket and withdrew a 500-*soles* note. "This is for an outstanding job!" he said, handing it to an overwhelmed Davíd. "And I've got a few others in my group who I'll send out to you later this afternoon. Cheers!"

Cheers, indeed! Here before me stood a young man with tears in his eyes, staring hard at the first money he had ever *earned* in his life. I knew the feeling, and you know it, too.

I winked at him, and turned on my heel to go back into the Sheraton—this time to stay.

I returned to my room on the sixteenth floor, and began to write reports associated with my own employment. But from time to time I peered over the balcony of my room, only to see young Davíd slaying the Goliath of competition he never feared, and only once did I see him without a customer. I laughed as I watched him develop a style that never failed to hook a passerby: He would bow stiffly to them, and say in an unhalting voice, "Señor, I am zee BEST!"

A few hours later, after sunset, my phone rang. It was the concierge in the lobby. They had, he said, caught a little street urchin trying to sneak up the elevators to my room, but before they threw him out they felt they should call me, because he kept threatening them that I would "chase them over the Andes" if indeed they threw him out.

"Señor," I said as formally as I could, accenting every syllable, and carefully trilling every "r," "That young street urchin is my business partner. Send him up at once!" I couldn't see Davíd's face, of course, but I could picture him drawing himself up to his full four-foot height, dusting off his shoe box, and marching smugly to the elevators.

When I opened my door, he held out his hands. They were piled high with 100-*soles* coins, atop a stack of 500-*soles* notes. I was astonished.

"I don't know how much is yours, Señor Brúce, but I must pay you," he said quite seriously. We counted the money. He had earned enough to pay back my $9.00 investment, and to pay me my return of 1 per cent, which itself amounted to 12 *soles*, or 2.7 cents. He was left, at the end of his first day, with the equivalent of $2.70. But he knew that from here on he was going to make a good deal of money, now that his initial debt had been paid off in full.

As he turned to leave, he extended his small, polish-covered hand. "Señor," he said softly, "Someday I will have enough money to come see you in America!"

I gripped his hand firmly. "Davíd, that's a wonderful thing to say. But there's plenty of time for that. You've got a lot to give to *Perú*!"

A few moments of silence passed before he looked up at me. "I will give it," he said, and I released his hand.

He stopped and turned back on his way down the hall. I thrust out my hand, with my thumb pointed firmly upwards. "¡*Arríba*!" I shouted down the hall. Upwards!

"¡*Arríba*!" he shouted back, arching his free arm into the air. Then we both laughed, for dangling precariously from his blackened thumb was a polish cloth. □

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"Insider Trading": The Moral Issue

by Ridgway K. Foley, Jr.

Sabena Dowd, an engineer for Super Software, overhears a conversation during a morning elevator ride to her office on the 38th floor of the New Market Building. She observes the two passengers leave the elevator on the 27th floor. She knows—as does anyone who can and will read the building directory—that the 27th floor is the exclusive domain of Reuben & Rotten, investment bankers reputed to specialize in acquisitions, mergers, leveraged buy-outs, and other common financial market activities. Sabena also recognizes one of her departing fellow passengers as Richard Rotten, a partner whose visage has appeared on several recent occasions in both the social and the financial pages of local publications. Neither Mr. Rotten nor his companion make any attempt to hide or disguise their discussion from others in the car; indeed, they take no notice of anyone else.

The gist of the conversation leads Sabena Dowd to conclude that International Thundermug Corporation (ITC) may represent an excellent investment opportunity. She confirms her conclusion by a venture to the public library that noon hour, during which time she reviews not only the latest annual and quarterly reports of ITC, but also the analyses of several financial writers; this quick study suggests that ITC has scant debt, solid cash assets, strong market share, and experienced management. Sabena calls a national brokerage house where her account executive assures her that, in his mind, ITC is an "excellent stock." She buys 1,000 shares of ITC at $25.00 a share, the midpoint of the selling range for the last twelve months. Within a week, *Barron's* and *The Wall Street Journal* report that International Thundermug, counseled by Reuben & Rotten, has agreed in principle to acquisition by Old Arrogant Foundry (OAF), a nationally known conglomerate famed in the news as a "raider." Both ITC and OAF are listed on the New York Stock Exchange. ITC stock opens the next day at $57.00 a share. Sabena calls her friendly neighborhood discount broker and sells out her position, pocketing a neat short-term $32,000 profit. Has she engaged in that currently odious and heinous offense of "insider trading"?

Shocking as it may seem to those of us steeped in traditional ethics, the answer is not clear-cut. In fact, situations such as these perplex many honest and well-intentioned individuals daily, stifling their productive endeavors and creating a fear of criminality in the decent and the ethical. No one disputes the necessity for rules preventing fraudulent conduct and overt misrepresentation; unfortunately, the "insider trading" arena extends far beyond ordinary boundaries of proscribed activity and accepted ethical definition.

This paper will not discuss the "extension of knowledge" or entrepreneurial analyses of normative rules regarding security transactions. More qualified scholars have honed in on the value of open information markets in the absence of activity which is coercive or deceitful in the customary sense.[1] Instead, this essay seeks to consider, in cursory fashion, the essential *ethical* or *moral* standards which are as-

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sumed, seldom enunciated, and virtually never understood under the "insider trading" rubric. The hypothetical situation proposed in the opening paragraph—sounding all too much like a law school examination question—with some modifications, illustrates some of the issues which settle like a plague upon our marketplace.

Is Sabena Dowd an "Insider"?

Is Sabena Dowd an "insider"? Not in any ordinary sense. She merely overhears an open conversation; she occupies space where she has every right to be; she has not eavesdropped, as by tapping a telephone or employing a spike mike; she does not represent any party to the transaction, nor is her employment in any manner connected to the acquisition, save in the fortuitous sense of use of a common elevator to unrelated offices. Under these circumstances, one would suppose that Sabena Dowd would be free to act on this information; after all, she does run a real risk of *loss,* as anyone who has acted on "tips" gleaned from the beauty shop, the shoeshine stand, or the singles' bar can testify with sorrow.

Nonetheless, the current frenzy instilled by the envious busybodies of the day forecasts a trend which would or could indict Sabena Dowd.

One could modify the hypothetical to justify conviction. Suppose Sabena Dowd to be a lawyer retained to represent ITC or OAF. Most codes of professional responsibility prohibit attorney conduct violative of the retainer, at least in the absence of full disclosure and knowing consent by the affected clients. These rules form express or implied contractual promises; the breach of these promises provides justification for a civil action by any victimized party. Note well, however, that under traditional legal analysis, the only "victim" would be Sabena's *client,* and proof of any *harm* (assuming a freely traded security) is difficult to fathom.[2] While the common law recognized a few "third party beneficiaries" entitled to sue for a broken contract to which they were not parties, such occasions represent the extraordinary rather than the commonplace. Again, it is difficult to conjure up a readily recognized third party beneficiary in the example.

A similar modification could result in a similar analysis if Sabena were employed by Reuben & Rotten, and if her employment agreement expressly forbade participation or investment in transactions in which the employer acted as counsel. Accountants and auditors, for example, often insert such covenants in their employment agreements if the governing professional body does not expressly prohibit professional-client transactions.[3]

In similar fashion, if Sabena had broken into the offices of ITC, OAF, or Reuben & Rotten, and secured private information by stealth or force of arms, few would find her innocent of all wrongdoing, although "insider trading" would prove to be a particularly inept description of her crime.

Thus, Sabena Dowd in the opening example does not come within any of the suspect categories which might justify penal sanction. She violated no implied or express covenant in a recognized professional code. She breached no term of an employment contract. She engaged in no deceit, no theft, no robbery. She merely received information (which proved to be accurate and valuable) not available to the general public, acted upon it, and profited. Under what justificatory talisman could the law find her guilty of a criminal act or a civil wrong in the category of "insider trading"?

The most likely fundamental response is a resort to a redistributionist theory of envy: a perceived "public," represented by government minions, mistakes or labels Sabena's actions as blameworthy merely because she profited and someone else did not; therefore, under standard redistributionist theory, the law ought to take away her "ill-gotten gains" and figuratively spank her as well!

It would pay conceptual dividends to consider the theoretical support for rules and regulations prohibiting security transactions in cases where no force, fraud, or breach of contract takes place. Suppose Sabena Dowd served as an officer and director of ITC and that her employment agreement was silent as to investment in her company. Suppose further that she sat in the very inner councils of her company and participated actively in the ITC/OAF acquisition.

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Suppose that, by virtue of her position and participation, Sabena heightened her attitude concerning ITC as a profitable investment. What moral wrong does she commit by investing in, or trading, ITC stock on the open market? I suggest that Sabena Dowd, under such circumstances, has done no wrong and that the crime of "insider trading" (beyond the basic force-fraud-contract analysis) is *mala prohibita*, not *malum in se*.[4]

The Sources of Knowledge

One might urge that Sabena Dowd has engaged in misconduct by profiting from select or special knowledge. Two answers appertain. First, as the introductory hypothetical example illustrates, "knowledge" may be derived from several sources; also, "knowledge" may be quite wrong, as the redoubtable attorney, Charles Mackay, chronicled in 1841.[5] In the opening example, note that while Sabena overheard an "inside" conversation, she supplemented that information before making her decision by using sources available to anyone willing to dig: published company reports, written commentaries, and broker recommendations. In addition, she employed her background observations and deductive reasoning in recognizing Mr. Rotten from the daily press, and in deducing the measure of a good company (strong and vital balance sheet, market share, management). Each of these sources—and more—would be available to Sabena Dowd in the altered hypothetical case where she serves as an officer and director.

Second, and more importantly, no recognized and acceptable principle of ethics bars an entrepreneur, observer, or anyone else from taking action and making decisions based upon any and all information secured by means unconstrained by laws against fraud, breach of contract, and use of force.[6] Consider the fundamental tenets of personal behavior which are of such a nature as to deserve to be encrusted into law. One ought not cheat another or coerce him or steal from him; Sabena Dowd, in our "officer/director/insider" example does none of those things. Hence, one can argue cogently *against* the imposition of any civil or criminal barriers or penalties.

Can we torture some extended definition of deceit or misrepresentation which would bar Sabena's use of "inside knowledge" so posited? I think not. The common law elements of the civil wrong of "fraud and deceit," having survived the test of at least five or six centuries, still stand us in good stead. Fraud requires proof that A made a (1) knowing or intentional (2) false (3) representation (4) of fact (5) to B (6) intending that B rely upon the representation, and that (7) B did reasonably (8) rely upon the false statement (9) to his loss, detriment, or damage.[7] Modern tort law has extended liability in some jurisdictions to encompass negligent or inadvertent misrepresentation,[8] thereby modifying the first and sixth elements. Sabena has not violated either the strict or the attenuated version: In the "officer/director/insider" example, *none* of the elements can be shown!

Could or should the law *imply* a misrepresentation by Sabena's silent acquisition and use of knowledge? Not reasonably. Not pursuant to any established and logical moral code. As a practical matter, any rule of law compelling "full disclosure of all essential (or material) matters" would open up an unlimited realm of absurdity. For example, what is "essential" or "material"; to whom must disclosure be made and by what means; to what extent must the speaker ascertain that her disclosure is heard and comprehended; is disclosure required solely as to matters of investment or finance; if some disclosure must be made beyond the ordinary investment and financial context, what boundaries exist and whither privacy; if knowledge is acquired inadvertently and purely fortuitously (as in the original hypothetical) must that information be imparted; and myriad other inquiries too numerous to mention. The resulting quagmire of uncertainty leavened with a tattletale mentality could only increase the growing frustration indigenous to government regulation in an age of the busybody.

Ought the law impose a duty upon Sabena to abstain from use of "inside information" acquired without force, fraud, or breach of contract? Again, thoughtful ethical rules invoke a negative answer. No one *ought* to be compelled to share knowledge; the very essence of the ballyhooed right to privacy lies in a recognized domain from which each individual may ex-

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clude all others at will. To compel the distribution of knowledge not only truncates the normal workings of the marketplace but also erodes the essence of the individual by chipping away at his private preserve.

Conversely, no one *ought* to be constrained from the gainful (if risky) employment of knowledge secured without force, fraud, deceit or in breach of a binding contract. Extension beyond these given rules of constraint would, once again, create a living theater of the absurd. For example, under what circumstances should the noncoercive, nonfraudulent acquisition of knowledge result in prohibition or forfeiture? Indeed, the current murk of Federal and state statutes, regulations, and decisions concerning "insider trading" demonstrates the inadequacy, artificiality, and utter foolishness of regulators run amok.

Apparently, the proponents of "insider trading" legislation rest their case upon some sort of "fundamental fairness" argument.[9] Unfortunately, few lawmakers trouble themselves with essential analysis; they avoid difficult questions and engage in untenable assumptions. Hence, in the context of "insider trading," those lacking in secondary linguistic sophistication *assume,* without reflection, that Sabena has not acted "fairly" in our "officer/director/insider" modification. Yet, the vital inquiry persists: Why this assumption? She has not cheated or robbed anyone. She has not broken any contract. In short, she has not engaged in traditionally dishonest conduct.

"Aha!" cry Sabena's traducers. She has gained an "unfair advantage" and that, in and of itself, calls her conduct into question. Reflect. Almost everyone enjoys, or could create, an analogical "unfair advantage." After all, despite the pains and plans of generations of normative witch doctors, each individual remains precisely that, a discrete individual, ever so much distinct from every other living creature before and since. Moreover, an additional complication crops up inasmuch as the inexorable passage of time and events, leavened by the interaction of myriad human beings, constantly creates new and different challenges and circumstances. This ebb and flow of time and persons presents opportunities for the acquisition and employment of knowledge in many arenas of life, one of which concerns the creation, production, and distribution of goods, services, and ideas available to satisfy the subjective desires of fellow sojourners on this planet.[10]

Could or should the law *imply* a misrepresentation by Sabena's silent acquisition and use of knowledge?

Nor can one argue convincingly that Sabena acquired her "edge" fortuitously, although a random acquisition of values, talents, health, and the like ought not undermine the governing moral postulate. Normally, an "insider" such as Sabena in our "officer/director/insider" modification has achieved her status as a result of the satisfaction of the wants of others in the market,[11] and not by random chance.

In some circumstances, the law provides civil or penal sanctions for conduct which thwarts reasonable expectations of third parties or the public; does Sabena Dowd's hypothesized activity in the "officer/director/insider" example fall within this emerging jurisprudential concept? Again, I think not. Assuming, for argument's sake, the efficacy of such a legal doctrine,[12] under any standard the broken expectation must be *reasonably* held. Since the pertinent issue here concerns the existence or nonexistence of a *moral* condemnation of "insider trading," the inquiry must properly re-

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flect this limit. Properly phrased, then, does any individual possess a *reasonable* expectation that, as a moral principle, the "officer/director/insider" *ought* to avoid participation in security transactions where the actor may possess special knowledge?

No, for several reasons. First, one could not will the rule as a universal,[13] for the identical reasons discussed heretofore regarding the reduction to absurdity of an open limit on the use of knowledge. Second, any expectation would be unreasonable inasmuch as inconsistent and disparate rules of conduct would appertain to analogical situations: Consistency would vanish as the human tendency to create exceptions for self and to require strict compliance for others would prevail. Third, and most saliently, the general moral law which most neatly accords with human action in this ordered universe decries breach of express contractual covenants, theft, and deceit in this regard, but otherwise permits free, self-determined conduct. This historically accepted and proven norm rests upon a recognition that no individual ought to select for another and a rejection of the doctrine of "might makes right." Since Sabena's supposed conduct does not involve force, fraud, or breach of contract, no reasonable third person could expect her to renounce or eschew her opportunity or position.

This moral analysis gains currency from an examination of the nature of the use of "inside information." Two characteristics stand out.

First, "inside information" may be wrong, unprofitable, or both. Few commentators dwell on the point; yet, how many civil or criminal proceedings are prosecuted against users of "inside information" who lose? The information may be faulty; e.g., Sabena Dowd may overhear a conversation concerning an ITC/OAF buyout which is untrue. Or, the information, while accurate, may not produce expected and profitable results; e.g., the ITC/OAF buyout takes place but the market (the discrete conduct of millions of parties who act upon their subjective value systems) does not believe the combination to be beneficial and the price drops from $25.00 a share to $12.00 a share in a few hours. In either event, Sabena Dowd has lost as a result of her "insider trading"; who will weep for her?[14]

Second, consider the transient nature of much of what the pontificators label "inside information." In many instances, one can liken any price advance and profit to a tour of Reno blackjack tables or, more fittingly, idle participation in a government-sponsored lotto game. Often, the price fluctuation results not from some disguised use of secret knowledge but, rather, from psychological stampedes akin to those described by Charles Mackay.[15] The careful *and successful* investor normally considers fundamentals ever so much more important than hunches. Thus, the deductive investigation performed by Sabena Dowd in the opening example—review of reports and published opinions, study of management and markets—assays more likely success than a chance elevator encounter. Viewed in this manner, the assault on the "insiders" amounts to an envious claim upon gambling proceeds in place of a hypocritical but high-toned plea for ethical renewal.

Making Distinctions

In final analysis, then, the moral case for prohibition of "insider trading" hinges upon facile words lacking analytical depth. As with myriad other fields of concern, the human inability or unwillingness to make fine distinctions imparts a seminal flaw to the required study. Most folks—past and present—agree that the law ought to prohibit and punish assault, aggression, murder, fraud, deceit, cheating, and breach of solemn, voluntary contracts. In similar lingo, most accepted moral codes recognize and propound these normative principles.[16] Thus, if Sabena broke her contract, or stole her information, or achieved her gain by means of force or fraud, most civilized individuals would consider her conduct reprehensible and a fit subject for punishment. To the extent that "insider trading" constraints deter or penalize such acts, the law coincides with accepted moral principles.

The difficulty appears where some individuals or groups seek to impose different standards upon other parties. Expediency often impels these "law seekers" to equate their new propositions with a supposed rule of ethics; a "moral-ought" argument probably increases

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the chance of passage of legislation where Congressmen (1) cannot or will not think, and (2) fear voting against (what is perceived as) a *moral* rule. In these instances, ignorance or venality impede wise action: Normally, the "moral" or "ethical" doctrine proposed is questionable or inimical to a free society. Nonetheless, the proponents confuse those few, standard, accepted, historically tested moral principles with their own evisceral, proposed, self-serving beliefs of right and wrong.

It is one thing to assert that, as an ethical tenet, an executive ought not to own shares or trade in the securities of his employer, and to impose that qualification upon one's *own* activity. It is quite another matter to enact that proposition as an immutable normative rule, compelling all others to adhere to the standard. It is not so much the inefficacy of willing the postulate as a universal;[17] instead, it devolves to a recognition of the essence of human nature and the respect for the nonaggressive choice of *all* individuals.

In a free society, all individuals ought to remain untrammeled in their creative activities; the state should solve insoluble disputes pursuant to common rules of law, and should prevent or punish the aggressive use of force and fraud. The fundamental *moral* principle underlying the premises of a free society—that each human actor ought to remain at liberty to seek his own creative destiny as he sees fit—cannot exist in harmony with most of the common lore and foolish rules now applied to "insider trading." □

1. *See,* Manne, Henry G., *Insider Trading and The Stock Market* (The Free Press, New York, 1966); Manne, Henry G., "Insider Trading and The Law Professors," 23 *Vand L Rev.* pp. 547-590 (1970). But *see,* Ferber, David, "The Case Against Insider Trading: A Response to Professor Manne," 23 *Vand L Rev.* pp. 621-30 (1970); *see also,* Manne, Henry G., "Economic Aspects of Required Disclosure Under Federal Securities Laws," a Charles C. Moskowitz lecture published in *Wall Street in Transition: The Emerging System and Its Impact on the Economy* (pages 21-110) (New York University Press, 1974).

2. Professor Manne has argued long and cogently that empirical evidence demonstrates that "insider trading" does not harm long-term investors, and that insider transactions may well perform a very efficient and salient role in compensating the innovator and the entrepreneur. *See,* Manne, *op. cit.,* note 1, *Insider Trading and the Stock Market.* However, the presence or absence of a "victim" does not *necessarily* determine the *moral* propriety of human conduct, the touchstone of this paper.

3. This essay assumes, for sake of argument, the propriety of the existence of private codes of conduct, e.g., rules of professional bodies prohibiting representation of multiple interests. Clearly, such an assumption deserves a closer look on some other occasion, for *mandated* proscriptions tend to violate the fundamental rules of a free society to the extent they exceed the proper governmental function to prevent aggression and deceit and to settle disputes in a forum of common justice.

4. The traditional criminal jurisprudence of the common law employed this differentiation. "*Mala prohibita*" referred to an act which was unlawful only by virtue of legal proscription; "*malum in se*" connoted penal laws which punished conduct which was "evil in and of itself," something all civilized societies would consider wrong, with or without a formal legal sanction.

5. Mackay, Charles, *Extraordinary Popular Delusions and the Madness of Crowds* (London, Richard Bentley, 1841) recounts myriad examples of common knowledge gone awry. Among the analyses contained in the first 100 pages of this remarkable tome are the investment debacles of "tulipmania" and John Law. Legend records that Bernard Baruch, the wizard of Wall Street, took Mackay's chronicles to heart in achieving his astonishing financial success.

6. While it is also true that a market society thrives upon the free flow of information without the artificial barriers noted earlier, I will refrain from addressing that argument here since it is tangential to my main purpose. Professor Manne handles the matter most admirably. *See* note 1, *op. cit.*

7. *See, e.g., Kaufman Inv. Corp. v. Johnson,* 623 F2d 598 (9th Cir. 1980), *cert den* 450 U.S. 914; *Meader v. Francis Ford, Inc.,* 286 Or 451, 595 P2d 480 (1979); *Metal Tech Corp. v. Metal Techniques Co., Inc.,* 74 Or App 297, 703 P2d 237 (1985). Confirm 3 Restatement 55, *et seq., Torts Second* § 525 ff.

8. *See, e.g., Weiss v. Gumbert,* 191 Or 119, 227 P2d 812, 228 P2d 800 (1951); 3 Restatement 126-145, *Torts Second* §§ 552-552C.

9. Another practical impetus resides in the bureaucratic and dictatorial mind. Once regulation passes into law, the enforcement apparatus tends not only to perpetuate its own position but also to expand its territory. In some instances, this occurs out of a misplaced belief in the inerrancy of the administrative mind and vision; in other cases, the administrative agency seeks raw power. Since the primary impetus toward application and enforcement in the present milieu derives from the Securities and Exchange Commission, the reader can draw his own conclusion as to the effective motivation of that agency.

10. I suppose it is equally "unfair" that I was not born with the innate ability to play basketball in the manner of Bill Russell. A disappointed swain in an earlier time might have rued the fact that he was not born handsome or winsome, or that he did not meet his dream girl prior to her betrothal to another. An inventor might despair that he lacked the insight or the intelligence to recognize and apply the properties available to him to solve a problem or to provide a new product. Yet, these equally "unfair" situations *cannot* and *ought not* be redressed by law; Job wrestled with seeming unfairness many centuries ago.

11. The satisfaction of market demand may result from the activities of a third party. For example, perhaps Sabena inherited her position in a close corporation from her father or mother, or received it in a marital dissolution settlement. If the acquisition is noncoercive and untainted by fraud, the essential analysis prevails.

12. I will resist any hankering to digress into a discussion of the merits of the concept of "thwarted expectations" as a premise for legal responsibility. Observe, however, that the theory possesses a number of shortcomings, at least in its embryonic form.

13. Kant, Immanuel, *Fundamental Principles of the Metaphysic of Morals* (New York, The Liberal Arts Press, 1949), p. 19.

14. Both of these events may just as well occur in the "officer/director/insider" modification of our hypothetical. Executives also wear blinders; indeed, sometimes close vision proves the most myopic.

15. Note 5, *op. cit.*

16. One ought to except the Marxist and Fascist view of things in this regard, since those codes of conduct rest on the "might makes right" premise. *Query:* How many true adherents—as distinguished from the gulled and the quelled—to those doctrines exist?

17. Note 13, *op. cit.*

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Voluntary and Coercive Cartels: The Case of Oil

by David Osterfeld

An important policy consideration is the ability of cartels to control prices. Too often this issue is discussed without distinguishing between voluntary, or free market cartels and coercive, or state-supported cartels. This distinction is fundamental. Coercive cartels distort the market, resulting in serious inefficiencies which harm consumers. Voluntary cartels, on the other hand, enhance market efficiency and therefore benefit consumers. An examination of the various monopoly and cartel arrangements in the oil industry will highlight these distinctions.

1. Origins of the Oil Industry[1]

By the turn of the nineteenth century, whale and sperm oil had replaced wood and peat as the principal new energy sources. The whale industry boomed. By the 1850s whale and sperm oil prices began to soar as whales were being slaughtered faster than they spawned. Selling for less than 25 cents a gallon in the 1820s, whale oil prices rose to over $3 a gallon by mid-century, and occasionally reached as much as $10 a gallon—the equivalent of about $200 a gallon at today's prices.

Such high prices naturally led to the search for substitutes. Coal oil was viewed as the most likely replacement. But after visiting scientists at both Dartmouth and Yale, in 1854, a New York lawyer, George Bissell, became interested in the commercial possibilities of crude oil. He founded the Pennsylvania Rock Oil Company and hired an out-of-work drifter, "Colonel" Edwin Drake.

The usual method for producing oil at the time was to dig pits and allow the oil to seep to the surface where it was then skimmed off. Too little oil was obtained by this method to make it economically viable, and Drake decided that a more efficient method might be to apply to oil the same techniques that were used in searching for water and salt: drill for it. At Titusville, Pennsylvania, in the summer of 1859, Drake struck oil at 69½ feet and the crude oil industry was launched.

Supplying 25-30 barrels a day at $20 a barrel, Drake's well grossed $600 a day. Word quickly spread and the northern Pennsylvania landscape was soon dotted with oil rigs. Within a decade the Oil Creek Region of Pennsylvania was producing nearly 5 million barrels of oil a year and the price per barrel plummeted to 10 cents, less than the cost of the barrel itself. By 1870 about 75 per cent of the oil refineries were losing money.

2. The Standard Oil Monopoly

John D. Rockefeller, who in the 1860s founded what was to become Standard Oil, resolved, as John Chamberlain put it, "to 'stabilize' the oil market by eliminating competition."[2] Between 1860 and 1870, Standard Oil's share of the market rose from less than 10 per cent to nearly 90 per cent. During the so-called "oil war" of the 1870s, Standard began to buy out its competitors. Those who refused to sell were often driven out of business by Standard's prices. But the reason Standard was able to

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"buy out" so many of its competitors—by 1874 it had purchased 21 of the 26 Cleveland refineries—was that given the depressed state of the oil market at this time many *wanted* to be bought out and, as D. T. Armentano noted, the simple fact of the matter is that "the original cost of a refinery in 1865 was irrelevant in 1875" and Standard "paid the *best* market prices for properties that were almost bankrupt and so inefficient that most were subsequently closed down by Standard."[3]

Legend has it that those who refused to be bought out were driven out of business by Standard's "predatory pricing," i.e., selling below cost to drive competitors into bankruptcy and then exploiting the monopoly position by raising prices. There is no doubt that Rockefeller was a "savage competitor." But it is equally clear that Standard Oil did *not* practice predatory pricing. Such a policy, John McGee has pointed out, "would have been foolish; and, whatever else was said about them, the old Standard organization was seldom criticized for making less money when it could readily have made more."[4]

For one thing a policy of predatory pricing is very costly, and its cost is directly proportional to the firm's share of the market. Thus, predatory pricing is *most* costly to the largest firm in the industry since it has the largest share of the business. Losing more money than any other firm in the industry is hardly a way to establish "market dominance." Second, the notion of predatory pricing is logically flawed since it assumes "a 'war chest' of monopoly profits to see the firm through the costly battles," thereby implying that it *already* possesses the very monopoly the policy is supposed to achieve.[5]

Rather, in an industry characterized by waste and inefficiency, Rockefeller made Standard a model of efficiency and innovation. Standard Oil was the first firm in the industry to emphasize research, the first to expand its operations beyond the Appalachian area, the pioneer in developing overseas markets, in exploiting economies of scale, and in developing new marketing techniques. Thus, while the price of kerosene fell from 26 cents to 8 cents a gallon between 1870 and 1885, Standard was able to reduce its costs from 3 cents a gallon in 1870 to .45 cents in 1885. Standard, notes Armentano, "was relatively efficient, and its efficiency was being translated to the consumer in the form of lower prices for a much improved product, and to the firm in the form of additional profits."[6] Standard Oil's success resulted not from the illogical notion of predatory pricing but from the efficiency of its operation.

Nevertheless, even at the height of its success Standard was never able to fully monopolize the market. Between 1880 and 1895 Standard's share of the refining market fell from about 90 per cent to 82 per cent despite the fact that during the same period it reduced its prices from 9⅛ cents a gallon to only 5.91 cents. Standard's share of the market began to decline rapidly after 1900, i.e., well before the court-ordered dissolution of the "monopoly" in 1911, when gas and electricity began to cut deeply into kerosene sales. And the discovery of huge oil reserves in Texas, Oklahoma, and California—reserves which literally dwarfed those in the oil regions of Pennsylvania—further undercut Standard's position. By 1901, John Chamberlain has written, "the Rockefellers could no more dominate oil than King Canute could dominate the tides."[7]

Clearly, it was the free market, not the courts, which thwarted Standard Oil's attempts to monopolize the oil industry. Even more importantly, the case of Standard demonstrates that there is nothing evil or pernicious about a free market "monopoly." On the contrary, the consumers were the chief beneficiaries since the pinnacle of Standard's success coincided with the lowest prices in the history of the industry. In short, so long as there are no legal barriers to entry, i.e., so long as the market is free, no firm, even if it is the sole producer, can prosper unless it is able to benefit the consumers better than its competitors, actual or potential.

3. Domestic Cartels: The Role of State and National Governments

With a steady stream of new discoveries, domestic and foreign, the oil industry was beset during the first part of this century by what Christopher Tugendhat calls "an embarrass-

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ment of riches." The market price for oil fell from $1.30 a barrel in the late 1920s to 5 cents a barrel by 1930.[8]

The "waste" of both oil and natural gas during this time was astonishing. Since oil was more valuable than gas, wells were often permitted to simply "blow wild," allowing the gas to escape until oil was reached. The Bureau of Mines estimated that in Oklahoma between 1910 and 1912 the quantity of gas "wasted" or lost totaled 100,000,000,000 cubic feet annually. This was equivalent to 5,500,000 tons of coal, or enough to supply the fuel needs of nearly one million families for three years. This was not an isolated occurrence. The Glenn Pool field in Kansas "wasted" 50,000,000,000 cubic feet of gas between 1906 and 1912. The Cook Pool field in Texas allowed gas to escape at the rate of 250,000,000 cubic feet a day for 34 days before oil was produced. And the Santa Fe Springs field in California lost 50,000 cubic feet of gas for every barrel of oil produced.

Enormous quantities of oil were also lost. With the market flooded with oil, the excess was often stored above ground in gullies, creeks, and earthen reservoirs, where as much as 50 per cent was lost through seepage, evaporation, or burning. Stanley Clark reports that in 1914 the Healdton, Oklahoma oil field was so saturated with oil that motorists driving near the field complained that their autos were "axle-deep in oil." In the Cushing, Oklahoma field some 25,000 barrels of oil were allowed to run into the Cimarron River. And a nearby cotton field was "covered with oil for one fourth of a mile in all directions."[9]

The tremendous loss of this nonrenewable resource not only bothered the industry but offended the public, which viewed such activities as amoral if not actually immoral. And after the repeated failures of numerous industry price-fixing schemes and proposed production cutbacks and shutdowns, the industry turned to government for help.

Originally the industry looked to the state governments. But while several producing states established agencies to control production, with Texas' Railroad Commission and Oklahoma's Corporation Commission being the best known, enforcement was difficult. Illegal or "hot" oil continued to be produced in great quantities and transported across state lines, hampering state enforcement agencies. Thus, state regulation proved ineffective and prices remained "distressed." As Robert Engler writes:

> Voluntary restrictions on drilling and output along with private prorationing by the pipelines were inadequate for checking rising production. State laws were limited and disparate. . . . [Thus], the president of the API [American Petroleum Institute] pleaded for federal intervention to end the flush and famine cycles with their accompanying price fluctuations.[10]

A "Petroleum Code"

On March 7, 1933, just three days after President Franklin Roosevelt assumed office, the industry appealed to him for Federal assistance, and the President called a meeting for later that month. The result was the creation of a national "Petroleum Code" whose provisions, Engler notes, "paralleled the recommendations of the API." The oil bill was included as part of the National Industrial Recovery Act and passed on June 11, 1933. It gave the Secretary of the Interior "the power to fix prices, wages and hours of labor and to limit production to demand, and to control the importation of oil."[11] The drilling of any new well now required the advance consent of the Department of the Interior. Moreover, on July 12 the President issued an executive order making the shipment of "hot oil" a Federal offense. The result was quick and clear. In May 1933, the price of crude oil was 25 cents a barrel. By October it had risen to $1.08.

The Code established a rather complicated system known as "prorationing," in which the Interior Department would work through state agencies such as the Texas Railroad Commission to restrict production and thus raise prices. Each month the industry would supply the Bureau of Mines with information regarding the expected demand for oil. The Bureau then would fix production quotas for each producing state. The states were obliged to adhere to these quotas by virtue of their "voluntary" membership in the Interstate Compact to Conserve Oil

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and Gas, better known as the Compact Commission. Each state commission would then allocate its quota among the producing fields within the state. Production in excess of the prorationing orders was subject to confiscation.[12] When the Supreme Court declared the NRA unconstitutional in May 1935, Congress promptly passed the Transportation of Petroleum Products Act, better known as the Connally Act after its sponsor, Texas Senator Tom Connally, thereby keeping the components of the complicated price-fixing scheme—prohibition of "hot oil," input restrictions, and production quotas—intact.

But why the appalling waste of oil and gas? Usually reference is made to the magnitude of the new oil discoveries, both in the U.S. and abroad, which drove prices down, and to the relatively primitive technology, which made regulation of gas pressure and the control of gas and oil flows very difficult. There is no doubt a kernel of truth here, but there is a far more fundamental, underlying factor: the property rights of an owner of a plot of land, or more precisely the lack of such rights, to the minerals lying beneath the surface. According to the prevailing legal doctrine known as the "rule of capture":

> The owner of a tract of land acquires title to the oil and gas which he produces from wells drilled thereon, though it may be proved that part of such oil or gas migrated from adjoining lands. . . . A landowner, however small his tract, or wherever located on the producing structure, may drill as many wells on his land as he pleases and at such locations as meet his fancy, and he is not liable to the adjacent landowner whose lands are drained as a result of such operations. Likewise he may by means of a compression or vacuum pump, increase the production from his well though the result may be to drain his neighbor's property. The remedy of the injured landowner . . . has generally been said to be that of self-help—"go and do likewise."[13]

Clearly, the "rule of capture" made it rational, in fact necessary, to "waste" oil and gas. By legalizing what, in effect, was the principle of "loot thy neighbor," the "rule" required property owners to follow the strictly short-run policy of drilling and producing as rapidly as possible. Even if an oilman or speculator felt that the price would rise in the future, he could not hold the oil or gas off the market, for if he stopped his operations and capped his wells while his adjacent competitors continued their activities, the owner would lose both his oil and his capital investment.

For example, an operator near the town of Okmulgee struck a huge natural gas reservoir. He offered to sell it to the gas company. The company refused the offer but was able to get the local authorities to require the operator to cap his well to prevent the gas from escaping. The company then acquired the gas by drilling its own well on an adjacent plot of land and tapping into the same reservoir.[14]

"Wasting" Oil and Gas

Because of the "rule of capture," drilling at times became "so intense that the legs of derricks would intersect," says Tugendhat. Consequently, underground pools often would lose pressure so rapidly that great quantities of oil, perhaps as much as 90 per cent, would be lost, or recoverable only by expensive repressuring.[15]

Thus, the property owner was caught in a bind. He could not chance storing oil and gas underground where it could be looted by adjacent competitors. But neither could he afford to store much of it above ground since the cost of storage usually exceeded the market value of the product. Given the "rule of capture," the only "rational" policy was to permit wells to run open, allowing the "excess" oil and gas to be "wasted."

There can be little doubt that had the courts adopted the doctrine of "correlative rights" or "ownership in place"—that the landowner owns the oil and gas originally beneath his surface—the situation would have been much different. There would have been about as much chance of companies wasting their oil and gas as there is of a cattle rancher or chicken farmer wantonly destroying his entire stock of healthy animals. Since ownership in place would have required that an adjacent operator caught draining another's oil or gas would make repa-

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rations to the original owner, the principle would have permitted oil and gas to be stored underground, ready for use when prices began to rise. The result would have been to permit, in fact encourage, operators to adopt long-run conservation policies, thereby moderating the "flush and famine" cycles and their corresponding price fluctuations so bemoaned by operators and consumers alike.

In brief, the "rule of capture" produced appalling waste which was seen to justify government intervention to restrict production. But, as is so often the case, one intervention leads to another. As production was restricted and prices rose, imported oil began to enter the country and "illegal" domestic oil was produced. The former was dealt with by the imposition of tariffs, the latter by the Connally Act. Had the courts adopted a sensible approach to property rights, oil would not have been wasted and the justification for government intrusion into the industry would not have arisen.

There are additional ramifications. From about 1930 to 1970, Federal policy was to keep domestic oil prices high, relative to international prices, by a combination of prorationing and import restrictions. The result, sometimes referred to as a "drain America first" policy, was to artificially stimulate the consumption of American oil while reducing the consumption of foreign oil.

But American oil tended to be more costly than foreign oil. Even as early as 1930 a barrel of Venezuelan oil could be produced and shipped to the U.S. for 75 cents while the production cost for a barrel of domestic oil was about $1.75. And as American oil was being depleted, with the ratio of domestic reserves to annual production falling from about 20 to 1 to only 12 to 1 by 1960, costs began to rise. Meanwhile, with vast new discoveries, especially in the Mideast, the world reserves to production ratio rose to 40 to 1. For the Mideast it stood at 100 to 1.[16] While a barrel of Texas oil sold for $3.45 in the 1960s, a barrel of Persian Gulf oil sold for less than $1.00 and its cost of production was estimated at 10 cents.

Largely for military and national security reasons, duties on oil imports were relaxed during the 1940s, falling to just 10½ cents a barrel so long as the volume remained less than 5 per cent of domestic production and doubling if imports exceeded 5 per cent. Given the low import duties, rising domestic costs, and the international glut, imports began to soar.

In 1948 the U.S. became a net importer of

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oil. In 1950 imports were about 5 per cent of domestic production. By 1954 they were nearly 17 per cent and the industry began to push for higher tariffs. In 1955 the President's Committee on Energy Supplies and Resources suggested that imports not be allowed to rise above their 1954 level but recommended enforcement through "voluntary restraint" implemented through the oil companies. Voluntary restraints proved ineffective and, with imports well over 20 per cent of domestic production, mandatory quotas were decreed by President Eisenhower in 1958.

The quotas succeeded in shoring up domestic prices but created what *Fortune* termed "carnage in the world market." "Now that the U.S. is so hard to get into," said *Fortune* of the foreign producers, "where can they sell it and at what price?" "Prices abroad . . . are taking a beating. More and more crude . . . is being sold at reduced rates."[17]

With about 90 per cent of the budgets of the Mideast governments coming from oil revenues, the price collapse wrought havoc. Panicked by the price declines and angered at their virtual exclusion from the U.S. oil market, the producing countries began to map out a counter-strategy in 1959. In 1960 the Organization of Petroleum Exporting Countries, a "cartel to confront a cartel" as one delegate put it, was formed.

There is no doubt that in the absence of government intervention domestic oil prices would have been lower and international prices higher. Nor can there be any doubt that proportionally less American oil and more foreign oil would have been consumed. Finally, it is quite possible that with open access to the American market, and thus both higher prices and a larger volume of sales, OPEC might never have been formed. The next question is: What has been the impact of OPEC?

4. International Cartels: Achnacarry to OPEC

There has been a great deal of public concern over the repeated oil industry attempts to cartelize itself in order to regulate competition and raise prices. But in every case the results fell considerably short of the goals.

The first concerted effort to establish an international cartel occurred when secret meetings, sponsored by the "Big Three"—Jersey, Shell, and Anglo-Persian—were held at Achnacarry Castle in Scotland during the summer of 1928. The result, officially termed the Pool Association of September 17, 1928, but more commonly known simply as the Achnacarry Agreement, was an ambitious plan to "stem the rising tide of competition" by "freezing the market in its existing mold." Prices were to be determined by the "Gulf-plus pricing system" i.e., oil prices throughout the world would be equal to oil prices in the Gulf of Mexico plus shipping costs.

But agreement was short-lived. First, the members themselves found it next to impossible to agree on production quotas and price levels. And second, the "majors" were unable to secure cooperation of the "independents" who, Tugendhat says, "continued to export their oil at lower prices than the cartel members." As a result, "by November 1929 the association had collapsed."

There were repeated attempts during the next half decade to develop workable modifications of the Achnacarry Agreement. These included the 1930 Memorandum for European Markets, the December 1932 Heads of Agreement for Distribution, and the June 1934 Draft Memorandum of Principles. But, as Tugendhat says, these agreements "were treated rather like the Ten Commandments, as a set of rules to which all pay lip service but few follow to the letter. . . . For all their power, the majors could never gain complete control over most of the larger markets, any more than Rockefeller had been able to impose his will in the United States during the 19th century."[18]

In brief, the extensive experience of the oil industry with voluntary cartelization—cartelization not enforced by government—clearly shows that it was never effective in controlling either production or prices. It has been estimated that no more than 50-60 per cent cooperation was ever attained, and it seems likely that this figure exaggerates the amount of actual collusion since it ignores the role of markets in spontaneously equalizing prices for the same products. Moreover, the *only* way the majors could "control" their markets was through the

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maintenance of low prices accompanied by, as in 1966-67, periodic "price wars" to drive out the independents. Since cartels are supposed to be bad because of their ability to exploit consumers by charging high prices, the question is: If this is the way *voluntary* cartels operate, what is the harm? The answer: There is none!

But what of OPEC, which is normally seen as the prime example of a cartel which has been effective in controlling oil prices? There are two important questions: (1) Is OPEC a coercive or voluntary cartel? (2) How effective has it been in controlling prices?

The first question is relatively easy to answer. According to its principal founder, Venezuelan Minister of Mines and Hydrocarbons, Dr. Juan Pablo Perez Alfonso, OPEC was to be a "worldwide Texas Railroad Commission." Its goal has been to raise and then control the international price of oil by restricting its production. But the Texas Railroad Commission is a government agency. Since it can use the apparatus of the state to compel companies to comply with its edicts, the Texas Railroad Commission and other state regulatory agencies have been the key components of a coercive cartel.

It is true, of course, that OPEC members are countries. But they are *sovereign* countries. Thus, no OPEC member can coerce any other member. Nor is there any supra-OPEC agency empowered with coercive authority. Thus, the effectiveness of any OPEC agreements depends on the *voluntary* acquiescence of its members. In short, OPEC is a *voluntary* cartel, or a "club" as Perez Alfonso put it. It is a Texas Railroad Commission without the power of the state to back it up.

The second question is more difficult to answer. How effective has OPEC been in controlling prices? First, OPEC was formed in 1960 with the stated purpose of raising prices. But its members never could agree on a scheme to reduce production, and it was clearly ineffective during its first decade. In 1960 the volume of oil in international trade was 9.0 million barrels a day; in 1970 it was nearly 26 million barrels. Thus, "the price of oil did not go up; in fact it declined through the 1960s."[19]

It is the "price shock" of 1973 that is commonly seen as the beginning of OPEC's control over prices. In October of that year OPEC announced an embargo on oil to the United States because of U.S. support for Israel in the 1973 Arab-Israeli War. OPEC also announced a cutback in production and a price rise to $5.12 a barrel. In December the price was increased to $11.65 a barrel, a quadrupling of prices in just a few months. Doesn't this indicate market control by a voluntary cartel?

There are several factors which need to be considered to understand why this is *not* the case. First, there is substantial evidence that by 1970 the oil "glut" was gone and the world, in fact, was facing an oil "shortage." Demand for oil had increased 7 per cent a year from 1950-73. In 1940, for example, coal accounted for two-thirds of the world's energy. In 1965 coal and oil each accounted for 37 per cent of total energy consumption. By 1980, oil's share of world energy consumption stood at over 40 per cent; coal's had fallen to 30 per cent.

On the other hand, due in part to the artificial stimulus of the controls on foreign oil, U.S. reserves were quickly being depleted. This problem was compounded by the fact that as new sources of domestic oil became increasingly difficult to find and extraction costs rose, U.S. production peaked and by the early 1970s was actually declining.[20]

The result of these trends was an extremely "tight" market. This is shown by the fact that prices began to rise even *before* the 1973 embargo. In February 1971, for example, oil prices rose 50 cents a barrel. And by early 1973, months before the October embargo, prices on the spot market—a free market for small quantities of "excess" oil—were up to $20 a barrel, or over five times the official or "posted" OPEC price at the time.

Second, an analysis of oil industry profits shows that with rising production costs associated with offshore and deep drilling, the high returns of the 1950s were gone. During the 1960s profit rates fell below those in the far less risky manufacturing sectors, and by the early 1970s they stood at an all-time low.[21] Since incentives and exploration are closely related, it is clear that domestic production could not be maintained much longer at their current levels in the absence of significant price increases. In fact, U.S. production was already declining.

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The final factor is the 1973 Arab oil "embargo." An embargo is an attempt to punish a country or region by imposing an abrupt halt in the flow of a particular good, in this case oil, to the embargoed country. When the embargo is imposed, prices in the embargoed country should rise while production in the embargoing countries should be curtailed. And when the embargo is lifted, production in the embargoing nations should increase, causing prices in the embargoed countries to return to "normal." The problem is that the 1973 "embargo" didn't work this way. First of all, although prices did quadruple, the embargo was never very effective. It was marked by massive "cheating" and defections among cartel members. Moreover, OPEC production declined less than 15 per cent in 1974-75, and its exports to the "embargoed" U.S. increased dramatically between 1973 and 1977. And finally, rather than declining at the termination of the embargo, oil prices actually *increased* slightly.

All these factors indicate that, as Paul MacAvoy put it, OPEC "never really controlled the world crude oil market. Rather, market forces were the dominant factor all along."[22] The pre-1973 prices were far too low to be maintained much longer.

High prices are neither good nor bad in themselves. Prices are signals revealing relative scarcities. The embargo merely highlighted how swiftly, dramatically, and unexpectedly the situation had changed from glut to famine. It also stimulated a market response to the new situation. In fact, the temporary 15 per cent decline in OPEC production appears less likely to have been the product of a conscious cutback by OPEC than a rational response to reduced world demand stemming from the 1974 recession. OPEC's policy, both collectively and individually, has been aptly described as that of " 'groping' toward an unknowable 'optimal' pricing path," that is, of charging what the market would bear.[23]

Likewise, the doubling of prices in 1979 cannot be attributed to cartel-like behavior by OPEC for, as Dermot Gately notes, by 1979 OPEC discipline "had broken down." Rather, the price rise was a result of another tightening of the market—prices on the spot market reached $40 a barrel—due to attempts by consuming countries to stockpile oil and thereby protect themselves from a possible loss of access to Mideast crude following the political upheavals in that region, especially in Iran. While the panic buying was in response to political events, there can be little doubt that oil prices were market-driven rather than cartel-determined.

The worldwide dependence on OPEC oil was aggravated by the U.S. government's imposition of price controls on domestic oil and gas in 1973. It is ironic that the U.S. government, which for decades had artificially stimulated the production of U.S. oil, responded to the "shortage" by imposing price controls on domestic producers which, by discouraging domestic production, artificially stimulated increased reliance on foreign oil.

Finally, it should be noted that consumers reacted to the higher energy prices just as one would expect—higher prices stimulated more efficient use of energy. Between 1973 and 1984 the Western industrialized nations increased energy efficiency by one-third. As a result, by 1984 energy consumption was actually less than it was in 1973, despite higher GNPs.[24] Between 1973 and 1985 OPEC's share of world crude oil production fell from 56 per cent to 30 per cent. During the same period, oil's percentage of total energy production declined from 48 to 39, while the shares for oil substitutes such as coal, gas, nuclear, and hydroelectric all rose.

It therefore became increasingly difficult for OPEC to maintain prices at their 1979 level. Between 1979 and 1985 OPEC production was halved, falling from about 30 to 15 million barrels a day, with Saudi Arabia bearing the bulk of the cutbacks. Finally, in an attempt to increase its dwindling oil revenues, Saudi Arabia reversed course in November 1985, and began to increase production. Oil prices plummeted, with OPEC members trying to underbid not only non-OPEC countries, but each other as well.

In brief, OPEC never was able to act with the cohesion required for the successful operation of a cartel. While OPEC may have affected the *timing* of the oil price increases, it does not appear that it affected their ultimate levels. The

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quadrupling of prices in 1973 was not the result of cartel price-fixing, although it may have appeared that way at the time, but reflected the dramatic change in the world oil situation. Moreover, the increases helped to rationalize a market that had become badly distorted due to decades of government meddling. Finally, the normal market-induced adjustments to higher prices stimulated a movement away from OPEC oil and, ultimately, the 1985 collapse of OPEC prices.

From Achnacarry to OPEC, history shows that attempts to create international oil cartels with the ability to control prices have uniformly failed. To the extent that they "controlled" the market, they have done so by keeping prices extremely low. To the extent that they have increased prices, they have been undercut by non-member rivals, and the cartels have collapsed.

5. A Sensible Energy Policy

The final issue is to determine a sensible energy policy. Such a policy may be defined as one which assures access to ample energy at minimum cost, i.e., with the least sacrifice of other goods and services.

Businesses must operate efficiently to earn profits or at least avoid monetary losses. Those that provide consumers with what they want at the lowest prices earn the largest profits. Those that fail to do so suffer losses and, if changes are not made, go bankrupt.

Government, in contrast, is *inherently* inefficient. Government does not acquire its revenues by the voluntary purchases of consumers but by compulsion, i.e., taxes. These are then allocated among a multitude of competing programs and agencies.

There are two fundamental differences between the operations of businesses and governments. First, payments to businesses are voluntary. Payments to governments are compulsory. Second, payments to businesses are made in exchange for specific goods or services. That is, they are part of the *same transaction*. But with government, payments and receipts of services are *two distinct operations*. Payments are made at one time; services are rendered at another time. Payment may be made by one set of individuals; services may be rendered to another set. The problem is that since there is no direct market test for government services, there is no way for consumers to evaluate their effectiveness and worth.

For example, government may claim that there is a shortage of roads, police, teachers, or oil, but it has no market test to see whether there actually is a shortage. And since government is not in a position to ascertain accurately the relative demands for its services, there is no way for it rationally to allocate its revenues among its competing uses.[25] This has important ramifications for energy policy since if access to energy can be achieved through other, nongovernmental, methods, then efficiency considerations would rule out the use of government.

The question then is: Is government necessary to insure access to ample energy? Energy access can be achieved by (1) securing access to oil, (2) developing adequate substitutes for oil, or (3) a mixture of the two.

Let us first consider oil. The major concern is that OPEC now possesses over 60 per cent of proven world reserves. The industrialized nations of the West, including the United States, have 13 per cent. The U.S. alone possesses slightly less than 5 per cent.[26] The fear is that, as Unocal chairman Fred Hartley has put it, given the magnitude of inexpensive oil in the Mideast—production costs in Mideast oil fields are estimated at less than $2 a barrel, while costs in Alaskan and North Sea fields are about $20 a barrel—OPEC is in a position to increase production drastically. This would drive down oil prices, thereby "stimulating demand even as it shut down American production and virtually ending this country's search for new energy sources." Since this would make the U.S. "dangerously dependent on foreign—OPEC—oil," America, he says, simply "cannot afford so-called cheap oil." The proposal is for an oil import fee which would "create a floor price of, say $27 per barrel, which should be high enough to support continued American exploration and development."[27]

The irony of the proposal is apparent: It would be a return to a "drain America first" policy that, as we have seen, is largely responsible for the rapid depletion of American oil re-

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serves in the first place. Moreover, its ramifications are also clear: By substituting higher-cost American oil for cheaper Mideast oil, an import fee would stimulate the rapid consumption of the already small American reserves, thereby making the U.S. *more*, not less, dependent on OPEC. Finally, the position reduces itself to the rather paradoxical proposition that the government should institute permanently higher oil prices now because of the possibility of temporarily higher energy prices at some unspecified time in the future.

It is simply not true that "energy security" is directly correlated with the quantity of imported oil. "Energy security" depends at least as much—probably even more—on the diversity of suppliers. The 1973 price increases stimulated the search for oil in many countries. As a result, the oil industry has become immeasurably more diverse. The U.S. now imports oil from close to 30 countries. The problem is that since many of these are relatively high cost producers, an import fee, by isolating the American market from imports, "would push down the world price for oil, thereby discouraging exploration for oil in other countries."[28] This would reduce the diversity of supply, thereby rendering the U.S. *more* dependent upon a single supplier—OPEC. In short, the immediate effect of an import fee would be higher domestic energy prices. Its long-run result would be the *exact opposite* of its intended effect: It would make the U.S. more, not less, dependent on OPEC.

In contrast to an import fee which would create a dual price structure—higher oil prices domestically and lower oil prices internationally—free trade could equalize domestic and foreign prices. Since this would keep domestic prices below what they would be with an import fee, free trade would reduce production of American oil. And, by increasing demand for foreign oil, it would help to maintain the diversity of the current oil market, thereby insuring continued American access to oil. It is logical to conclude, therefore, that the free market is far more likely to insure continued access to oil than a policy of government intervention.

But what of alternative energy sources?

Although there are many who disagree on both the low and high sides, the consensus is that there is somewhere between a 50- and 90-year supply of recoverable oil left in the earth. Clearly, alternatives to oil will have to be developed. Over the past decade the Department of Energy has spent literally billions of dollars to develop such alternatives but, as Christopher Flavin, a Worldwatch researcher and hardly an exponent of the free market, recently wrote: "Crash government programs to develop major new energy sources have generally been dismal failures, and similar efforts to deal with future crises show no signs of being any more successful. But smaller efforts, taken by companies and individuals in response to higher prices, have an excellent record."[29]

In fact, such government programs have probably done more harm than good. The reasons are not hard to find. Government decisions are based on political, not economic, criteria. The basic problem is the asymmetry between the costs and benefits of government programs. Since the costs of each program are dispersed among the taxpayers as a group, the cost of any *particular* program to any *individual* taxpayer is minute. This means that the individual usually is not even aware of the program and, if he is aware of it, would quickly recognize that the costs *to him* of opposing the program overwhelm the benefits that would accrue to him from the program's termination. Thus, his rational strategy is to minimize his losses by *not* actively opposing the program.

But when the beneficiaries of a program are a relatively small group, the benefits can be considerable for *each member* of the group. Consequently, while the average taxpayer has no incentive to lobby against a particular program, the potential beneficiaries have a strong incentive to lobby for its passage. Given this asymmetry, it's not difficult to see which side will win.

Gasohol is a classic example. Gasohol is a mixture of 90 per cent gasoline and 10 per cent ethanol. Grain is used in the production of ethanol, and the farm lobby has been able to channel large amounts of tax money into farmers' pockets by getting the government to establish a program to subsidize the production of ethanol. But it is so expensive that some economists "have compared that process to stretching our supplies of hamburger by adding

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a few extra pounds of tenderloin steak. The value of the resources necessary to produce gasohol is simply a great deal more than the value of the resources (even at high crude oil prices) necessary to produce straight gasoline."[30]

The tragedy is that the commitment of large sums of money to such wasteful projects reduces the amount of investable capital and, correspondingly, the degree of innovative activity that normally would occur in the market. Such programs, therefore, actually *impede* the development of alternative energy sources. For example, the high cost of supplying electricity to the remote rural areas of this country in the early part of this century stimulated the development of windmill and hydroelectric industries. But the decision of the national government to supply rural residents with heavily subsidized and thus artificially "cheap" energy priced these alternative sources out of the market.[31]

Whether the alternative to oil will be coal, nuclear, solar, hydroelectric, an entirely new discovery or invention or, as seems likely, some mix of these, is impossible to tell. But it is clear that the free market, where investors and entrepreneurs risking their own money are rewarded with profits for successful ventures and penalized with losses for unsuccessful ones, is far more likely to produce viable alternative energy sources than the government.

If the above analysis is correct, then the market is not only more likely to supply energy more efficiently than government, it is also more likely to supply it in ample quantities and without interruptions.

In short, *regardless of what OPEC does*, the best energy policy is *laissez faire*.

6. Conclusion

The distinction between voluntary (market-spawned) and coercive (government-created) cartels has been examined. It was found that while coercive cartels have seriously distorted the market, thereby harming consumers and wasting oil, voluntary monopolies and cartels, from Standard Oil to OPEC, have actually benefited consumers by eliminating waste and increasing the overall efficiency of the industry. Finally, it was shown that the free market is far more likely to insure continued access to energy than a policy of government intervention. □

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26. The percentages have been calculated from OPEC, *Facts and Figures*, (Vienna: Carl Umberreuter, 1980), Table, p. 17. See also Christopher Flavin, *World Oil: Coping With the Dangers of Success* (Worldwatch Paper, 66, 1985), Table, p. 28.
27. Fred Hartley, "Predatory Saudi Tactics Peril U.S. Petroleum Industry," *Los Angeles Daily News* (April 13, 1980). Also see "Import Fees: The Reason Why," *World Oil* (May, 1986), pp. 20-24.
28. G. Anderson and K. J. Kowalewski, "Implications of a Tariff on Oil Imports," *Economic Commentary* (September 1, 1986), p. 2.
29. Flavin, p. 53.
30. Richard Stroup and John Baden, "Responsible Individuals and the Nation's Energy Future," *Cato Journal* (Fall, 1981), p. 432.
31. *Ibid.*, pp. 427-429.

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Federal Job Training: Road to Nowhere

by James Bovard

In 1964, at the height of the Great Society, the Johnson Administration decided that government should provide a job for every teenager who couldn't find employment. The first summer jobs program, the Neighborhood Youth Corps, was established in 1965 to give poor urban youths "meaningful" work experience and to encourage them to stay in school.

The Neighborhood Youth Corps was the first of a long line of failures. According to several General Accounting Office (GAO) reports, the program had no effect on dropout rates and did not prevent a large increase in youth crime rates. In fact, the GAO concluded in 1969 that some workers "regressed in their conception of what should reasonably be required in return for wages paid." (GAO, *Review of Economic Opportunity Programs,* 1969)

Ten years later, conditions were no better. GAO found that "almost three of every four [urban] enrollees were exposed to a worksite where good work habits were not learned or reinforced, or realistic ideas on expectations in the real world of work were not fostered." (GAO, "More Effective Management is Needed to Improve the Quality of the Summer Youth Employment Program," February 20, 1979)

When a Federal program fails, politicians can always change its name to create the appearance of reform. In 1972, after years of embarrassing failures, the name of the Neighborhood Youth Corps was changed to the Summer Program for Economically Disadvantaged Youth. In 1977, after more exposés and boondoggles, the name was changed to the Summer Youth Employment Program (SYEP). But the new names have not solved old problems.

To call SYEP a "jobs program" is a serious abuse of language. In Washington, D.C., kids last summer busied themselves building a model cardboard city or attending a "Basketball Reading Incentive Camp." (*Guide to the Mayor's 1986 Summer Youth Programs*) Some "workers" complained to the *Washington Post* that they spent all their time listening to lectures about South Africa, nuclear war, and birth control. One "enrichment exercise" consisted of tours around Washington, visiting Capitol Hill, the Washington Harbor, and elsewhere. In Phoenix, SYEPers painted pictures of cars on sides of buildings. In Baltimore, kids were paid for passing out toys and for chauffeuring cats and dogs to old folks' homes. (*Baltimore Blue Book of Summer Jobs,* 1986)

With Federal funding on the line, local governments are becoming aggressive employers of first resort for young people. The New Hampshire Job Training Council used a rock band to drum up interest among teenagers. Phoenix tried to get Jesse Jackson to come and dignify their program with his presence. These gimmicks are understandable since many localities cannot find enough young people to fill Federally funded positions.

Programs like SYEP are a prime contributor to illusions and unrealism among young people about the world of work, and actually may have increased long-term unemployment. Columnist William Raspberry noted, "We are raising a

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generation of kids who don't know the meaning of work." (*Washington Post,* December 2, 1977) Raspberry cited summer jobs programs among the culprits.

A study by Harvard professors Jon Crane and David Ellwood concluded that "roughly 40% of SYEP jobs simply displace private employment" for minority youth. This is especially damaging to young people since, as the Task Force on Youth Unemployment reported in 1980, "private employment experience is deemed far more attractive to prospective employers than public work."

Government jobs programs saturated black inner cities in the late 1970s. In 1978, up to half of all employed black teenagers had jobs with government programs. In the following years, the sharpest declines in employment and labor force participation were among the groups most heavily targeted by government jobs programs. A National Academy of Science study (*Youth Employment and Training Programs,* 1985) found that government employment and training programs isolate disadvantaged youth, thus making it harder for them to fit into the real job market. At the same time, these programs did not reduce criminal activity among participants.

The federal government also offers youth job training under the Job Training Partnership Act (JTPA). According to the Labor Department, less than 40 per cent of JTPA youths get jobs —even for a single day. JTPA inflates its apparent success rate by adding job placements to other "positive terminations"—including returning to school and development of "youth competencies." "Youth competencies" usually refer to "employability skills"—such as "world of work awareness," making change from a dollar (*Pittsburgh-Allegheny Co. PIC Newsletter,* November 14, 1984) and demonstrating "effective non-verbal communication with others." (Department of Labor, *An Introduction to Competency-Based Employment and Training Programming Under the JTPA,* 1985) This allows administrators to measure their success by the number of certificates they hand out, rather than by the number of people who get jobs.

The fallacy underlying all government job training programs is that the private sector lacks incentives to train workers. Naturally, private employers prefer that job applicants be already trained; but where there is a shortage of skills and a demand for services, there always are incentives to train.

If Congress wants to help unemployed teenagers, it should abolish the minimum wage. This is the greatest impediment to the hiring and training of teenagers with no skills or experience. The higher the minimum wage, the less money employers can afford to devote for training and still hope to earn a profit. Were it not for the minimum wage, workers could exchange less pay for more training, and the process would be far more efficient and cheaper than any government intervention or subsidy.

The failure of Federal training programs is especially tragic since most teenage unemployment is caused, directly or indirectly, by government labor market interventions.

In 1947, the minimum wage was very low, and teenage unemployment was not significantly higher than the general unemployment rate. But, in the 1950s and 1960s, the minimum wage was repeatedly raised—and teen unemployment soared. By the 1970s, black teen unemployment was double that of whites —around 40 per cent.

The minimum wage, by trying to increase wage rates artificially, makes it no longer profitable to hire the least skilled workers. Without a minimum wage, even the least skilled worker can negotiate a price at which it is profitable for an employer to hire him. But, with a $3.35 an hour minimum wage, plus Social Security coverage and other state and Federally mandated costs, a worker's productivity must at least cover these total costs, or he will not find work.

Teen unemployment is also boosted by government restrictions on the jobs and hours teens are permitted to work. For example, while government provides expensive, ineffective training programs to prepare teenagers to be construction workers, regulations in many states and localities prohibit 16- and 17-year olds from working in the construction industry.

The answer to teen unemployment is less government, not more. If government would remove its minimum wage and other barriers to employment, there would be jobs for all teenagers who want to work. □

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Why Government Jobs Programs Destroy Jobs

by Thomas J. DiLorenzo

In an effort to spur economic development, several bills have been introduced in Congress to resurrect Depression-era "public works" programs. Such legislation has been heartily supported by organized labor and other interventionist groups.

But such programs cannot reduce unemployment any more than the Depression-era programs did. The unemployment rate was higher in 1939—despite millions of workers placed in government jobs by the Roosevelt administration—than it was in 1931 on the eve of President Roosevelt's election.

The reason why government jobs programs cannot create jobs is straightforward: Even though the programs may "create" jobs for some workers, the resources to pay for the programs must be extracted from the private sector. Taxing the private sector reduces *its* ability to create jobs, so, at best, government jobs programs can only alter the *composition* of employment, not the total volume. More government jobs are created, but at the expense of fewer private-sector jobs.

This basic economic truth is nothing new. In 1848 French economist Frederic Bastiat wrote that he "loses patience completely" over claims that government spending programs can create jobs. Whenever the state opens a road, builds a palace, repairs streets, or digs a canal, wrote Bastiat, "it gives jobs to certain workers. That is what is *seen*. But it deprives certain other laborers of employment. *That is what is not seen.*"[1] Bastiat concluded that so-called government jobs programs were, therefore, "a ruinous hoax, an impossibility, a contradiction."

Indeed, there is much evidence that government jobs programs not only do not create jobs; they actually eliminate them. For instance, in 1982 the Wharton Econometric Forecasting Associates estimated that a government jobs program proposed during that year would cause a net *reduction* of 20,000 jobs. In another study of the same program, Nobel Laureate economist Milton Friedman forecast that as many as 100,000 jobs would be lost by that particular government "job creation" program.

This might seem illogical at first, but there are sound reasons why government jobs programs are bound to destroy jobs. One is that public works projects must comply with the Davis-Bacon Act, which stipulates that wages paid on Federal contract work must be the "prevailing wage" in the area, which is usually the union scale, as determined by the U.S. Department of Labor. The jobs that are "created," therefore, are relatively highly paid; the ones that are displaced elsewhere in the economy are usually lower paid. So if a union worker makes, say, $12 an hour in Davis-Bacon wages, he or she may be replacing two less-skilled workers who, because of their lower skills, might be able to make only $6 an hour. One job is created, two are eliminated.

Another reason why government jobs programs increase unemployment is that much of

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the money extracted from the taxpayers to pay for the programs isn't used for wages, but for "administration." The federal government's own Office of Management and Budget (OMB) reported that during the 1970s only 2 per cent of all the money allocated for local public works programs went to persons previously unemployed. Much of the money apparently went to "the lawyers, accountants, engineers, and consultants" brought in to plan the programs and to workers already employed.[2] And many public works programs are capital intensive, requiring large expenditures on tools, machinery, and raw materials, not wages. Those expenditures may stimulate employment in the tool and machinery manufacturing industries and in the raw materials industries, but it still must come at the expense of fewer private-sector jobs elsewhere.

Because of these expenses OMB found that the cost of "creating" jobs with public works programs has been as high as $198,059 per job annually. Thus, the tax money spent on each government job could have paid for as many as ten $20,000 a year private-sector jobs.

A Substitution Effect

Another stumbling block to governmental job creation is that many local governments typically substitute Federal subsidies for their own spending on public works. As Robert Vaughn, an adviser to former New York Governor Hugh Carey explained, "federal jobs programs retard public works spending by state and local governments because they defer their own projects in the hope of getting federal aid."[3] An example of this substitution effect is the CETA program. East St. Louis, Illinois, once had two-thirds of its municipal work force on the CETA payroll; San Diego and Miami had 47 per cent; and 16 per cent of all municipal workers nationwide were on the CETA payroll in 1978.[4]

Despite the logic and evidence suggesting that government jobs programs are unable to create jobs, on net, they are still politically popular, as they were over 100 years ago in Bastiat's time. Their popularity stems from the fact that the jobs "created" are highly visible, whereas the jobs lost are difficult to identify as being caused by the programs.

Politicians always make a great fuss over the jobs they create, but understandably ignore the ones they have taxed out of existence. Jobs programs promise something for nothing, but in reality they rob from Peter to pay Paul. This is an inevitable consequence of governmental intervention in the economy, for as James R. Schlesinger once wrote:

> The tool of politics . . . is to extract resources from the general taxpayer with minimum offense and to distribute the proceeds among innumerable claimants in such a way as to maximize support at the polls. Politics, so far as mobilizing support is concerned, represents the art of calculated cheating—or more precisely how to cheat without *really* being caught.[5]

Thus, there is a moral as well as an economic dilemma posed by governmental jobs programs. The dilemma will not be resolved until it is widely recognized that it is illegitimate for government to grant special favors to one group of citizens at the expense of another. Those who defend government jobs programs on moral grounds (i.e., that they display compassion toward the unemployed) must be asked the following questions: How is it moral to put one group of citizens out of work, for reasons they do not understand, in favor of another? How is it moral for politicians to deceive their constituents by telling them that government is "creating" jobs, when they know in fact that it is not?

The best situation is one in which more jobs are available to *all* citizens at the expense of no one. And the evidence is overwhelming that free enterprise and economic growth are the only means of achieving this. The real job generator in the economy is not the public but the private sector.

The performance of the U.S. economy from 1983 to 1987 is a textbook example. During that time the private sector created over 13 million new jobs despite the absence of any new government jobs programs, making the United States the envy of the world as far as job creation is concerned. Moreover, contrary to claims by organized labor and other interventionists that these new jobs are low paying, the U.S. Department of Labor recently reported

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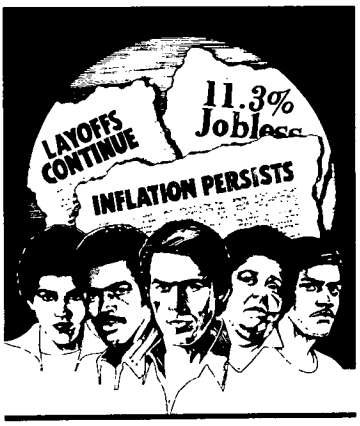
that nearly half of the new jobs are in the highest-paid category as classified by the Labor Department, and only 6 per cent are in the lowest paid. This performance is in stark contrast to our European trading partners. Despite a greater reliance on governmental jobs programs, there has been a net *loss* in jobs in Western Europe during the past 15 years.

The key to job creation is private-sector economic growth. And it is no secret that governmental policies conducive to economic growth are tax reduction, expenditure restraint, monetary stability, and regulatory relief for American industry. The best way to create jobs is to have a healthy private sector. Government spending on jobs programs (and most everything else) may provide some citizens with valuable benefits, but job creation is not one of them. □

1. Frederic Bastiat, *Selected Essays on Political Economy*, ed. George B. de Huszar (Irvington-on-Hudson, NY: Foundation for Economic Education, 1964), p. 16.
2. See James Bovard, "Busy Doing Nothing: The Story of Government Job Creation," *Policy Review*, Spring 1983, pp. 87-102.
3. "Broad Recovery Called Essential to Job Creation," *New York Times*, November 28, 1982.
4. Bovard, "Busy Doing Nothing," p. 95.
5. James R. Schlesinger, "Systems Analysis and the Political Process," *Journal of Law and Economics*, October 1968, p. 285.



The Politics of Unemployment

by Hans F. Sennholz

Why is unemployment so high in the United States? Why will unemployment continue to rise in the years to come? Why do politicians continually attempt to legislate "full-employment" even though such programs are doomed to failure?

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The Trade Deficit

by Ken S. Ewert

Unsound economic ideas, like cats, seem to have several lives. Errors which have been laid to rest in past decades and even centuries are often resurrected, and once dusted off and dressed in new apparel, they haunt humanity yet again.

One such spurious idea is the national "balance of trade" notion which was articulated by the mercantilist writers of the sixteenth, seventeenth, and eighteenth centuries. Although soundly refuted by Adam Smith and following classical economists, the concept has reemerged and is today the focus of national attention.

The U.S. trade deficit, which has increased dramatically since 1983 and was a record $170 billion in 1986, is a leading concern of our nation's politicians, labor leaders, businessmen, and media. We are solemnly warned that jobs are being lost as we are invaded with "cheap" foreign goods, American industry is losing a "trade war" and is threatened with extinction, and America is becoming a debtor nation. To sit by and do nothing about the trade deficit, according to a growing opinion, is tantamount to national suicide.

It is most often suggested that the solution to this "trade gap" is a policy of increased protectionism. To those who value liberty this is a serious threat on at least two accounts. First, import restrictions directly lessen the individual's freedom to exchange, and correspondingly increase the government's power over the affairs of its citizens. Second, and perhaps more importantly, individual freedom may be further attenuated because the impoverishment accompanying trade restrictions will likely cause people to invest more power in the civil authority. Such was the experience of America during the 1930s when the economic havoc created by the Smoot-Hawley tariff was instrumental in an unprecedented expansion of government power.

The balance of trade notion owes its modern existence to mercantilist writers. Prominent in the thinking of these early economists was the desirability of the natural acquisition of gold and the concomitant (or so they thought) increase in national power. A nation could best accrue specie, they reasoned, by exporting more goods than it imported. This was called "a favorable balance of trade." The payment for the excess of exports over imports would take the form of a gold flow into the nation and this new money (which mercantilists confused with wealth) would stimulate the nation's production and add to its power.

Two erroneous ideas pervaded mercantilist thought. First, trade was mistakenly seen as a contest in which one party inevitably bested the other. In each exchange there was a winner and a loser, and a nation "won" at trade if it exported more goods than it imported.

A second fundamental flaw in mercantilist thinking was its holistic approach to economic analysis. The nation was considered to be an entity in and of itself, separate from and more important than its individual citizens. Thus international trade was not analyzed from the

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perspective of the individual participants, but rather from the perspective of the nation, or more accurately, the state.

Mercantilism Refuted

Beginning with the publication of David Hume's essay "Of the Balance of Trade" in 1752, the mercantilist arguments for the pursuit of a favorable balance of trade were soundly refuted. Hume pointed out that no nation could have a continuously "favorable" balance of trade because gold inflows would serve to increase domestic prices and consequently discourage exports while at the same time encouraging imports. The result would be an outflow of gold, and a nation's balance of trade would tend toward equilibrium in the long run.

Adam Smith and following classical economists, notably David Ricardo, refined the case for free trade and exploded other mercantilistic myths. The holistic approach to economic analysis was soundly rejected since, as Smith wrote, "What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom."[1] The nation was seen as the sum of its citizens and thus "national gain" was simply the total of all individual gains. Furthermore each trade did not have a winner and a loser, but rather was a mutually advantageous exchange, undertaken only because each individual believed himself to be gaining. And if each individual gained in each trade, how could the nation suffer from a trade deficit?

The holistic thinking of the mercantilists has been readopted and modified by much of modern economic thought, and today's emphasis on "national trade" has confused many people. To understand what a trade deficit is, we must start with the individual. After all, it is individuals and not nations who actually trade goods and services.

When an individual agrees to exchange one commodity for another, he does so only because he believes it to be to his advantage. This is true for both parties in any trade; it matters not whether the exchange takes place across the street, or across national boundaries.

Consider an American trading with a Japanese citizen (we could just as well take a New Yorker trading with a Californian). Suppose that the American values a Japanese television set more than a particular piece of machinery which he has produced, and at the same time, the Japanese values the piece of machinery more than the television. If such is the case, they will exchange. This, of course, is simple barter—goods are exchanged directly for goods—and there is no monetary intermediary. But notice that no one has a "deficit" in this transaction—both parties are satisfied that they have gained more than they have given up.

Of course, very few barter exchanges actually take place. It would be difficult for the person desiring the TV set to find a person in need of the particular machine tool which he had to offer in exchange. Rather, the exchange is facilitated by the use of money, which allows the machine tool manufacturer to sell his product to anyone who wants it and then use the money to purchase the specific good (in this case a TV) from the Japanese producer. The Japanese producer can convert these dollars into the American product (in this case a machine tool) which he desires.

Although these individuals do not exchange directly, but through several intermediary buyers and sellers, the exchange is in principle the same as if they did. Ultimately the good produced by the American "pays" for the good received from the Japanese, and the Japanese good "pays" for the good received from the American. In other words, exports pay for imports.

But how then is a trade deficit possible? If in each exchange both parties are paying via goods and services, how can there ever be a national imbalance of trade? Why would foreigners agree to give up their products to us if they are not receiving American goods and services in exchange?

The answer is that they do not. Since each party trades only to gain, the difference between the value of the tangible or real goods which are given up by the "surplus" country and the value of the real goods which are received must be made up of other types of valuable goods. Each trade must balance; the deficit of real goods must be countervailed by a surplus of another type of exports.

And it is. The difference is made up of a net transfer of dollar claims from American indi-

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viduals to foreign individuals. The trade deficit, which is more accurately called the merchandise trade deficit because it includes only the real goods traded, is possible only because on a net basis foreigners are willing to accept dollars in exchange for their goods and services, and temporarily hold these dollars. In other words, the U.S. currently is running a "surplus" of dollar exports with the rest of the world.

Why Value the Dollar?

Why are foreign individuals willing to accept paper assets in exchange for their real goods? The obvious answer is that they value the American dollar highly. This is true for a number of reasons.

First, the dollar has become, since the demise of the Bretton Woods agreement, the reserve currency of the world. It serves the function previously served by gold, allowing foreign central banks liquidity and the ability to inflate their currency.

Second, until recently, the real return on U.S. securities has been very attractive to foreign investors. Relatively high interest rates combined with the relatively low inflation of the dollar during the first several years of this decade (in comparison to other major currencies) has made dollar investments popular with foreigners. Foreign holdings in the U.S. are now over one trillion dollars and are growing at an annual rate of $100 billion.[2]

Third, the U.S. and thus the dollar, has become an international haven for "capital flight" from the less stable and less free countries of the world. Morgan Guaranty estimates that during the past ten years $188 billion has come into the U.S. from eighteen developing countries.[3]

Fourth, because of massive foreign loans during the 1970s, there is a substantial demand for dollars to service these debts. Countries such as Brazil and Mexico can only repay their dollar-denominated loans by running trade "surpluses" with the U.S. They obtain the necessary dollars the only way they can—by trading real goods for dollars on a net basis.

And fifth, because of widespread currency debauchment among foreign countries, the American dollar serves as a parallel money throughout Latin America, Southeast Asia and even parts of southern Europe.

These factors explain why on a net basis, foreigners are willing to "buy" our dollars with their goods. But the high demand for the dollar does not by itself explain the continuing U.S. trade deficits.

The other major factor enabling America's consumption to exceed its production is the Federal Reserve's policy of monetary inflation. In any inflation, the individuals who initially possess the newly created money gain the maximum benefit. This has been the case in the international arena where, because of dollar inflation, individual Americans have found themselves the initial recipients of new money.

Having increased nominal incomes, but not wishing to increase their individual "cash balances," Americans have spent this new money for real goods, either domestic or foreign. New dollars spent on domestic goods tend to bid up domestic prices, and foreign goods (which have not yet been bid up) become more attractive to American consumers. Eventually dollars pour abroad in exchange for foreign goods. Inflation of this "world currency" has allowed Americans to bid goods and services away from other international buyers.

On net, Americans have been trading dollars for real goods because, for a number of reasons, they value the foreign goods more highly than their dollars. At the same time, on a net basis, foreigners are valuing the dollars they receive more highly than the real goods they are giving up. Can we say which party is getting the better deal? To do so would suggest that one is either irrational in its dealings or does not know its own best interests.

The questionable validity of seeing a trade deficit as "bad" and a trade surplus as "good" becomes apparent. If we can say that the U.S. is experiencing a trade deficit because it is losing dollars, we can just as accurately say that the Japanese are experiencing a trade deficit, as they are losing automobiles and television sets. Which are more valuable, dollars or real goods? This is purely subjective decision. While one person values dollars or dollar-denominated investments more highly, another person places a higher value on real goods.[4]

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If an individual is not harmed by running a "trade deficit," can a nation be? The answer is no. The economic gain or loss of a nation, as the classical economists recognized, is the gain or loss of its individual citizens. But what about charges that the trade deficit has led to unemployment and declining wage rates, the uncompetitiveness of American industry, and the debtor nation status of America?

The Effect on Labor

It is popular to speak of the trade deficit as "exporting" American jobs. It is thought that when American consumers buy foreign goods produced with "cheap" labor they are disemploying or at least reducing the wages of American workers. The assumptions underlying this argument are specious.

The first erroneous assumption is that there is a fixed number of jobs in the world, and that the employment of a foreigner means the corresponding disemployment of an American. This is reminiscent of the mercantilist thought of past centuries which assumed a fixed amount of wealth in the world. The number of jobs, or more accurately the demand for labor, is not some quantity mysteriously mandated from above, but rather is completely dependent upon the price (wage rate and benefits) that workers demand for their labor. If the price of labor is held above the marginal productivity of labor, employers cannot profitably hire, and unemployment is the result. Unemployment has everything to do with the price of labor and nothing to do with the foreign goods we purchase.

Second, this argument overlooks the factors that determine wage rates. Wage rates in America are not comparatively high because we have more humane employers or a more benevolent government. They are higher because the marginal productivity of American workers is higher, and this is due primarily to capital investment. Nothing, aside from declining marginal productivity, threatens the level of wages. Therefore, the low level of foreign wages does not threaten the wage rates of Americans.

This does not deny that the wage rates in specific American industries may be affected by imports. If American consumers begin to purchase less expensive foreign steel instead of domestic steel, the wage rates within the American steel industry will tend to fall as producers cut costs to compete. But at the same time, unseen benefits are also occurring. The real wage rates of all Americans will rise since the less expensive imports allow them to either buy more products containing steel, or buy the same amount of steel-related goods and more of other goods. Furthermore, since the division of labor is enhanced, both the productivity of labor and wage rates are generally improved.

The third faulty assumption in this argument is that when dollars are spent on foreign products (as opposed to domestic products) wealth and employment are lost forever to American industry. But the dollars received by foreigners do in fact return to demand American goods and services in one of two ways. They either will be invested in American capital and equities markets, or spent on American real goods and services. If the former, they serve to lower capital costs for American entrepreneurs and contribute to American employment by lifting the marginal productivity of some workers over institutional barriers. To the degree that dollars are redeemed for real American goods and services, they are "votes" for efficient American industries and contribute directly to employment. In either case, net jobs are not lost because of imports, but rather are diverted from less efficient industries to industries at which America has relatively lower production costs.

Does the trade deficit indicate that American industry is losing a "trade war" and is becoming uncompetitive? First of all, we must bear in mind that trade is never comparable to a war. In war the stronger triumphs at the weaker's expense, but in trade the weaker gains as does the stronger. In war armies cross borders to harm and destroy people; in trade goods cross borders to please and enrich people. While losing a war denotes national weakness, imports signify no such thing but instead are a sign of a country's relative inefficiency in the production of a particular good. It is certainly true that each time a consumer buys an imported good it reveals that a particular domestic industry is inefficient relative to a for-

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eign producer. But this only means that America is the same as every other nation and has relative strengths and weaknesses of production.

Furthermore, imports only reveal the areas at which American industry is relatively inefficient; they are not the source of this inefficiency. The competitiveness of any industry depends on the costs it must pay for capital, labor, government, and resources. It is true that some traditionally competitive American industries may, for any number of reasons, become uncompetitive in relation to imports. But contrary to the beliefs of many politicians, trade restrictions do not improve an industry's competitiveness and only end up punishing all consumers by forcing them to pay higher prices. In the long run, trade barriers only lower the real wages and living standards of all people.

Why Is the U.S. a "Debtor Nation"?

Another evil attributed to the trade deficit is America's debtor status. It is true that the U.S. has been a "debtor nation" since 1985. This sounds ominous. But the word "debtor" is misleading in this case since there is no outstanding debt which must be paid by Americans to foreigners. The debtor status of the U.S. simply means that the dollar value of foreign investments in the U.S. surpasses the dollar value of assets owned by American individuals abroad.

This has come about because during the past several years Americans have freely chosen to relinquish ownership of dollars (and dollar assets) in return for real foreign goods.[5] This influx of foreign capital poses no threat to the well-being of the nation, and is actually beneficial. In 1986, while American individuals and corporations saved some $680 billion, the various levels of government borrowed $143 billion to finance deficits.[6] The foreign capital inflow of $144 billion (made possible by the trade deficit) in effect cancelled the capital consumption of government. It has temporarily allowed private investment to proceed as if there were no budget deficit.

While the trade deficit probably has been beneficial to the American economy, a major cause of the trade deficit, the inflation of the U.S. dollar, will have adverse effects. As the exchange markets respond to the increased quantity of dollars in circulation, the dollar depreciates in value. In the past, foreign dollar holders—both individuals and governments—have invested many of their dollar holdings in fixed-return securities. Their capital investments have kept U.S. interest rates below what they otherwise would have been.[7]

But the depreciation of the dollar has punished these holders of fixed-return securities. Becoming less willing to bear this loss, foreign investors are seeking other uses for their dollars. Such is happening today as foreign-held dollars are flowing into U.S. equity markets. Foreign holdings of U.S. equities increased by $5 billion in 1985, $23-$25 billion in 1986, and will increase by an estimated $35 billion in 1987.[8] The recent stock market boom is partially fueled by this foreign buying.

When the speculative boom in the stock market comes to an end, foreign dollar holders will likely use their dollars to buy real American goods and services. This will cause domestic prices to be bid up. Because a shrinking amount of foreign-held dollars will be available to finance U.S. capital demand, domestic interest rates also will rise. Interest rates will increase further as savers become aware of rising prices and take into account the future depreciation of their dollars. As the dollar depreciation continues, American goods and services will become more attractive to foreign consumers. And at the same time, because of the depreciating dollar, imported goods will become more expensive for American consumers. The trade balance will once again tend toward equilibrium.

Thus, the end of the trade deficit will likely be accompanied by high interest rates and inflated prices, and followed by a recession. But these undesirable consequences are not the result of the trade deficit *per se,* but of monetary inflation—the consequences of which have been forestalled for a time because of the unique position of the American dollar. The fruits of past monetary sins are at last revealed as the economic distortion becomes apparent. As foreigners convert their dollars into real goods and the inflow of foreign capital sub-

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sides, interest rates will rise and entrepreneurial "malinvestments" will be exposed.

If the trade deficit is a national problem, it is for two reasons. First, its eventual end will exact a price for the Federal Reserve's past excesses, and individual Americans no longer will be able to consume more than they produce. And second, because of special interest groups and the mercantilist perspective of many politicians, the trade deficit threatens to lead to protectionist legislation. This is despite the fact that the actual threat posed by a trade deficit is minimal or non-existent. In the words of economist Herbert Stein, "There must be something more serious to worry about."[9]

While the trade deficit itself is not threatening, government interference with international trade is. Any political efforts to rectify what is seen as "the trade problem" are certain to harm the economic interests of the vast majority of Americans. As far as the trade deficit is concerned, there is little doubt that any government cure will be worse than the imagined disease. □

1. Robert L. Heilbroner, *The Essential Adam Smith* (New York: W. W. Norton & Company, 1986), p. 266.
2. Jaclyn Fierman, "The Selling Off of America," *Fortune*, December 22, 1986, pp. 44-56.
3. "Foreign Money Finds Haven in U.S.," *The Wall Street Journal*, May 27, 1986, p. 2.
4. In retrospect we see that foreign individuals who have chosen to accept and hold American dollars have been harmed by the subsequent inflation and depreciation of their dollar assets. But the fact that people sometimes misjudge the future and take actions contrary to their best interests does not suggest that the individual's freedom should be lessened for his own good. Who could be a better judge of someone's interests than the person himself?
5. Americans can buy foreign goods or invest in American business, but they can not do both at the same time. To the degree that Americans are exchanging dollars for foreign consumer goods (obviously not all imports are goods for consumption), the trade deficit is an indication of our "present orientation." It indicates a preference for consumption over investment, or in other words, present enjoyment over future enjoyment. The trade deficit, however, does not cause this high time-preference, but is a symptom of it. Protectionist legislation would not change the time-preference of American consumers (i.e., stop people from consuming instead of investing), but only changes how time-preference is manifested (forcing consumer spending to shift from foreign to domestic goods). As Gary North writes: "Americans are increasingly willing to exchange their economic futures for present delights . . . What should the Federal government do about the short-sighted vision of American consumers? Is it the responsibility of the Federal government to pass legislation controlling people's time perspective? . . . Those who want to invest in American business should be allowed to invest." (Gary North, "Should American Business Give Up Smoking?" *Biblical Economics Today*, April/May 1987, p. 3)
6. Herbert Stein, "Leave the Trade Deficit Alone," *The Wall Street Journal*, March 11, 1987, p. 29.
7. Lewis E. Lehrman, "Trade War or Monetary Reform," *The Wall Street Journal*, January 28, 1987, p. 26.
8. Michael R. Sesit, "Overseas Holdings of U.S. Stocks Grow," *The Wall Street Journal*, February 27, 1987, p. 13.
9. Stein, p. 29.

In the December **Freeman:**

- "The Ancient Suicide of the West" by Nicholas Davidson
- "Scandals" by Joseph S. Fulda
- "The Polish Underground" by Lawrence W. Reed
- Index for 1987—author, article, and topic guide, from advertising to zoning.

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A REVIEWER'S
NOTEBOOK

The Closing of the American Mind

by John Chamberlain

Astoundingly, a very learned and difficult book about the state of higher education in the United States has been holding Number One place on *The New York Times* nonfiction best-seller list. And just as astonishing, a book detailing what should be done to repair our deficiencies in general knowledge has been running Number Two or Number Three.

The first book is *The Closing of the American Mind: How Higher Education Has Failed Democracy and Impoverished the Souls of Today's Students* by Allan Bloom, with a foreword by Saul Bellow (New York: Simon and Schuster, 392 pp., $18.95). The second book is *Cultural Literacy: What Every American Needs to Know* by E. D. Hirsch, Jr. (Boston: Houghton Mifflin Co., 251 pp., $16.95).

If people are really digesting and approving what Allan Bloom, a University of Chicago professor, has to say, it signals a remarkable change in our mental climate. It also tells something about reader persistence. Bloom develops his subject in a most roundabout way, and it is not apparent until he reaches page 336 of his book that we really know what he is after. He begins with a charge that, in the mid-1960s, our universities were offering students every concession other than education. There was a "great spiritual bleeding." When Bloom talked to his students about books, he got an impression that there was no printed word to which they looked for counsel, inspiration, or joy. There was always the girl who mentioned Ayn Rand's *The Fountainhead,* or the boy who had read *The Catcher in the Rye.* But the students had "nothing like the Dickens who gave so many of us the unforgettable Pecksniffs, Micawbers, Pips, with which we sharpened our vision." If the students lacked both books and heroes, however, they did have music.

At this point Bloom takes off on a most wrathful denunciation of rock music. "Rock," he says, "has one appeal only, a barbaric appeal, to sexual desire—not love, not *eros,* but sexual desire undeveloped and untutored." The real issue here with Bloom is that rock "ruins the imagination of young people and makes it difficult for them to have a passionate relationship to the art and thought that are the substance of liberal education."

Bloom's long chapter on "Relationships" laments a number of things that have a bearing on the failure of the universities to provide a unified education. Our discriminatory laws are now ancient history, and there are plenty of blacks now in college. But they don't share any positive intellectual or moral experience with white students. Generalizing from his days as a teacher at Cornell, Bloom notes that blacks insist in eating by themselves. "Integration," he says, "was just an ideology for whites and Uncle Toms." Black militants "had to threaten—and to do—bodily harm to black students with independent inclinations" to

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found a separatist system. Affirmative action in the colleges, says Bloom, "is the source of . . . a long-term deterioration of the relations between the races in America."

In this chapter on "Relationships" Bloom talks about love. "When I see a young couple who have lived together throughout their college years leave each other with a handshake and move out into life," he says, "I am struck dumb." But Bloom is not too dumb to perceive that such a couple could have little comprehension of Shakespeare's Othello, who killed for love. And Tolstoy's *Anna Karenina* would have little meaning.

Before getting down to the subject of course content in education Bloom has first to settle a lot of things about "value relativism." He assumes that his readers must know all about Hegel, Rousseau, Nietzsche, Freud, and Max Weber as well as Thomas Hobbes, John Locke, and Adam Smith. He also assumes that his readers must have an appreciation of Woody Allen.

There are long sections on what Rousseau and Kant did to improve upon the theories of the Eighteenth-Century Enlightenment. Locke and the French *philosophes* had established the domain of natural science. But they left out of account such things as "community, virtue, compassion, feeling, enthusiasm, the beautiful and the sublime."

After some 300 pages of general philosophy, which is always interesting, Bloom returns to what he has touched upon at the beginning, which is failure of the universities in the Sixties to stand up against the "pick and choose" fragmentation of the curriculum. "About the Sixties," he says, "it is now fashionable to say that although there were indeed excesses, many good things resulted. But, so far as universities are concerned, I know of nothing positive coming from that period; it was an unmitigated disaster for them. . . . The old core curriculum —according to which every student in the college had to take a smattering of courses in the major divisions of knowledge—was abandoned."

Bloom is not very hopeful that the old-time curriculum can be restored. The trouble is not with the natural scientists or with the champions of the humanities at the two extremes.

"The moral education that is today supposed to be the great responsibility of the family cannot exist if it cannot present to the imagination of the young a vision of a moral cosmos and of the rewards and punishments for good and evil, sublime speeches that accompany and interpret deeds, protagonists and antagonists in the drama of moral choice, a sense of the stakes involved in such choice, and the despair that results when the world is 'disenchanted.' "

—Allan Bloom

They could agree on the issue of sharing core time. It is the social scientists in the middle that make a good compromise impossible. Social science, says Bloom, "is a series of discrete disciplines. . . . There is no social science as an architectonic science. It is parts without a whole."

That is where Bloom more or less leaves us. E. D. Hirsch, in his *Cultural Literacy,* is just as critical of "cafeteria-style education" as Bloom, but he is rather more hopeful that strong disciplines in math, science, the humanities, history, and literature can be re-established. There can be a return to core teaching without sacrificing flexibility. "A common extensive curriculum," says Hirsch, "would ensure that students have some information about *Romeo and Juliet,* but in their intensive curriculum they might study *The Tempest* or *Twelfth Night* in detail."

Hirsch concludes his book with a 63-page list of dates, names, phrases, titles, and snatches of song and poetry that literate Americans know or should know. Rousseau is there along with Rube Goldberg, and Immanuel Kant is not too far away from King Kong. Woody Allen, however, seems to be missing, which could make Alan Bloom feel that he is one up on Hirsch.

The two books admirably complement each other, and it is a tribute to American readers that they have recognized this in putting them high for many weeks on the best-seller lists. □

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CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT

by Robert Higgs

Oxford University Press, 200 Madison Avenue, New York, NY 10016 • 1987 • 416 pages • $24.95 cloth

Reviewed by John K. Williams

This is a first-class volume, which in substance exceeds its title. It will prove invaluable not only to people with expertise, or wishing to acquire expertise, in American history, but to men and women anxious to understand the reversion in our age to the large, intrusive governments against which classical liberals of the 18th and 19th centuries fought with considerable success.

This is not to say that the volume is misperceived if its subtitle—*Critical Episodes in the Growth of American Government*—is taken at face value. In such chapters as The Progressive Era: A Bridge to Modern Times, The Political Economy of War: 1916-1918, and The Great Depression: "An Emergency More Serious Than War," the author provides a detailed historical analysis of significant turning points in the history of the United States.

Yet, in a very real sense, these chapters serve as case studies of a more general thesis—that government typically grows during a "crisis," real or imagined. In time of crisis, those who normally would oppose an extension of governmental power can be panicked into approving or even demanding such an extension. Rather than endure actual or anticipated social dislocations, or wait for the crisis to be dealt with by market processes, men and women facing a crisis insist that government "do something."

Professor Higgs rightly points out that "no single standard explanation can account for the timing of the extension of governmental authority over economic decision-making" and that attempts to provide what one might call a "monistic" explanation achieve simplicity at the expense of accuracy. Yet one constant can be observed—that crises provide the opportunity to extend government powers, and that rarely is the opportunity passed by.

Higgs concludes his study in a minor key. He holds that crises occasioned by many causes—"foreign wars, economic collapse, or rampant terrorism"—inevitably will characterize the future. "When they . . . [occur] governments almost certainly will gain new powers over economic and social affairs. . . . For those who cherish individual liberty and a free society, the prospect is deeply disheartening."

Yet that statement comes from the volume's penultimate paragraph. And although the minor key continues in the final paragraph, what is said there offers ground for hope. The author asserts that, while he hopes he is wrong, he is of the opinion that the process leading to an ever more intrusive government cannot be halted. He notes, however, that "Americans have been brought to their present inauspicious circumstances by, above all else, changes in the prevailing ideology. If ideologies are not mere superstructure, if ideas can gain sway through rational consideration in the light of historical evidence and moral persuasion, then there remains a hope, however slight, that the American people may rediscover the worth of individual rights, limited government, and a free society under a true rule of law."

This reviewer believes that ideas *can* most certainly "gain sway" through the educational work of organizations committed to liberty. Robert Higgs' qualified pessimism certainly has grounds. But so did the even greater pessimism voiced by Adam Smith. Yet the ideas Adam Smith and other classical liberals formulated and defended managed to inspire sufficient men and women to overthrow the nightmare that was mercantilism. Hence, while reading this thoughtful volume is not unlike witnessing a Greek tragedy, wincing as one observes a heroic character slowly but inexorably moving his or her way toward inevitable destruction, one can close the book not with a sigh of despair but with an intensified desire to do all one can to further the ideas and the ideals upon which liberty ultimately depends. □

(The Reverend Dr. John K. Williams of North Melbourne, Australia, has been FEE's summer scholar in residence for the past three summers.)

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THE RULE OF EXPERTS: OCCUPATIONAL LICENSING IN AMERICA
by S. David Young

Cato Institute, 224 Second Street, S.E., Washington, D.C. 20003
1987 • 99 pages $7.95 paperback

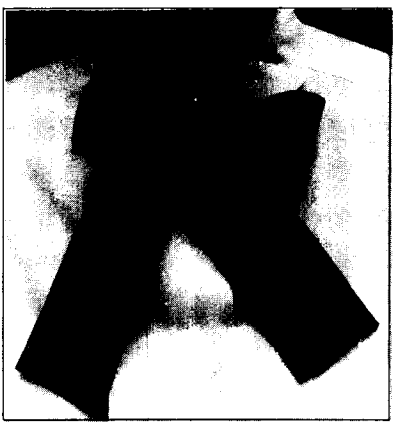
Reviewed by Tommy W. Rogers

Occupational licensure is a political process whereby various trades and professions are enabled to erect barriers against competition through the enforcement power of the state. Some 640 occupations in the United States require registration, and some 490 are currently licensed. This procedure limits consumer choice, raises consumer costs, increases practitioner income, and restricts entry opportunity without a demonstrated improvement in quality or safety beyond that provided by private certification.

Licensing confers monopoly advantages which enable practitioners of hundreds of services to charge above-market prices. The wealthy can afford to pay but the poor are often forced to do without. It's as if those who cannot afford a Cadillac are forbidden to buy a Honda.

But do we not need licensing to insure quality service and weed out quacks? No, says the author. Private certification which limits the use of certain titles—Realtor, for example,—and other nonintrusive mechanisms would afford substantially the same protection, without violating any basic freedoms. □

(Tommy W. Rogers is an attorney in Jackson, Mississippi.)



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The ideal of freedom is to let anyone do anything he pleases, as long as his behavior is peaceful, with government empowered to keep the peace—and nothing more. An ideal objective, true, but one that must be pursued if we would halt the continuing descent of our society from bad to worse. Nothing short of this will suffice. And unless we fully understand the ideal—and what makes for its attainment—we'll tend to settle for powerless, futile little pushes and shoves that yield no more than a false sense of something done.

—Leonard E. Read

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